Supreme Court of the United States

OCTOBER TERM, 1968

No. 280

UNITED STATES OF AMERICA,

Petitioner,

—v.—

SKELLY OIL COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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DOCKET ENTRIES IN DISTRICT COURT

No. 6181

1965 DATE	FILINGS—PROCEEDINGS
5-12-65	Complaint, filed. Summons Issued.
5-12-65	Summons returned, filed—served John M. Imel, U. S. Attorney at Tulsa, Okla., on May 12, 1965 and by mailing two copies to the Attorney General, Washington, D. C., by certified mail. (Fee $3.00)
7- 8-65	Defendant's answer, filed.
8- 3-65	Case set for pre-trial on Tuesday, August 17, 1965 at 4:30 P.M. (Fred Daugherty—Judge) 10:00 A.M.
8-12-65	Order removing pre-trial filed, postponed until further notice. (Fred Daugherty—Judge)
8-27-65	Case set for pre-trial on Tuesday, September 7, 1965 at 3:30 P.M. (Fred Daugherty—Judge)
9- 3-65	Case stricken from the pre-trial assignment of September 7, 1965, and case is to be submitted on statement of facts. (Fred Daugherty—Judge)
9- 7-65	Ordered by the Court that the case being submitted on stipulation of facts and briefs, the parties are granted until October 1, 1965 within which to file the stipulation, the plaintiff 30 days thereafter to file brief, the defendant 30 days thereafter to file answer brief, the plaintiff 20 days thereafter to file reply brief. (Fred Daugherty—Judge)
10- 1-65	Joint stipulation of facts, filed.
10-26-65	Brief of the plaintiff, filed.
11-26-65	Ordered by the Court that the defendant is granted until January 1, 1966 to file an answer brief and the plaintiff 20 days thereafter to file a reply brief. (Fred Daugherty—Judge)
1- 5-66	Defendant's motion for extension of time for filing answer brief, filed.

1966 DATE	FILINGS—PROCEEDINGS
1- 5-66	Order (a part of motion) filed granting USA until January 10, 1966 in which to file its answer brief. (NCH-BBB)
1- 7-66	Defendant's motion for extension of time for filing answer brief, filed.
1- 7-66	Order (a part of motion) filed, granting USA until January 10, 1966, in which to file its answer brief. (Fred Daugherty—Judge)
1-10-66	Brief of the defendant, filed.
1-27-66	Reply brief for plaintiff, filed.
6- 2-66	Findings of Fact, Conclusions of Law and Decision, filed; plaintiff recover stipulated amount, judgment in the sum of $20,932.64 plus interest against the defendant, defendant directed to prepare judgment. (Fred Daugherty—Judge) copies mailed.
6-21-66	Judgment filed and entered that in accordance with the parties' stipulation of facts, that the plaintiff have and recover of and from the defendant the amount of $20,932.64 with interest; and that the complaint and action be dismissed with prejudice insofar as any recovery greater than that above. (Fred Daugherty—Judge)
6-21-66	Copies of judgment mailed to counsel of record.
6-22-66	Notice of appeal, filed. Copy delivered to U. S. Attorney.
6-22-66	Designation of contents of record on appeal, filed.

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF OKLAHOMA

Pleas And Proceedings Before The Honorable Fred Daugherty, Judge Of The United States District Court For The Eastern, Western And Northern Districts Of Oklahoma, Presiding In The Following Entitled Cause:

SKELLY OIL COMPANY, PLAINTIFF

vs.

UNITED STATES OF AMERICA, DEFENDANT

No. 6181, Civil

COMPLAINT

The above named Plaintiff for its Complaint hereby alleges as follows:

I. This is an action arising under the Internal Revenue Laws of the United States, of which this Court has jurisdiction pursuant to Title 28, United States Code, Section 1346(a)(1).

II. Plaintiff is a corporation duly organized and existing under the laws of the State of Delaware, and maintains its principal office at 1437 South Boulder, Tulsa, Oklahoma.

III. This action is brought for an overpayment of income tax for the taxable year ended December 31, 1958 in the amount of $96,809.82, or such further amount as may be legally refundable, together with statutory interest thereon.

IV. At all times pertinent hereto, plaintiff has kept its books and filed its Federal income tax returns on the accrual basis, utilizing a calendar year.

V. (a) At all times pertinent hereto, Plaintiff has been a "regulated public utility" as defined in Section 7701

(a) (33) without regard to the limitation contained in the last two sentences thereof [formerly Section 1503 (c) without regard to paragraph 2 thereof] of the Internal Revenue Code of 1954, within the meaning of Section 1341 (b) (2) of such Code.

(b) During its taxable year ended December 31, 1958, Plaintiff, in settlement of litigation or under threat or imminence of litigation, was required to refund and repay $500,000.00 to Cities Service Gas Company and $5,536.54 to Dorchester Corporation, or a total of $505,536.54.

(c) The aggregate $505,536.54 represented excessive rate charges made by Plaintiff to Cities Service Gas Company and Dorchester Corporation with respect to natural gas produced by Plaintiff from its natural gas reserves, which was sold by Plaintiff to Cities Service Gas Company and Dorchester Corporation during the calendar years 1952 through 1957, inclusive.

(d) The entire $505,536.54 was included in Plaintiff's gross income for Federal income tax purposes during the period 1952 through 1957, inclusive, because Plaintiff had an unrestricted right thereto, in the following amounts:

Taxable Year Ended December 31	Cities Service Gas Company	Dorchester Corporation	Total
1957	$ 67,668.17	$1,276.07	$ 68,944.24
1956	93,094.52	1,406.23	94,500.75
1955	93,018.88	1,810.53	94,829.41
1954	120,064.70	1,043.71	121,108.41
1953	91,972.49	—	91,972.49
1952	34,181.24	—	34,181.24
Total	$500,000.00	$5,536.54	$505,536.54

VI. (a) Under date of September 14, 1959, Plaintiff timely filed its 1958 Federal income tax return (Form 1120).

(b) On its 1958 return, Plaintiff deducted the $505,536.54 it was required to restore in such year to Cities Service Gas Company and Dorchester Corporation, which, with other items contained therein, produced a tax liability for 1958 of $5,214,382.49.

(c) Said tax liability of $5,214,382.49 was paid by Plaintiff on the dates and in the amounts set forth below to the District Director of Internal Revenue, Oklahoma City District:

Date of Payment	Amount of Payment
10/13/58	$ 880,000.00
12/12/58	1,000,000.00
3/12/59	2,018,904.10
6/12/59	1,315,478.39
	$5,214,382.49

(d) On or about September 25, 1961, Plaintiff filed an amended Federal income tax return for its taxable year ended December 31, 1958, which reflected an additional tax due for such year in the amount of $2,618.84.

(e) Plaintiff paid said additional tax of $2,618.84, together with interest thereon of $397.13 on or about September 25, 1961 to the District Director of Internal Revenue, Oklahoma City District.

(f) Under date of July 6, 1962, Plaintiff received from the District Director of Internal Revenue, Oklahoma City District, a Revenue Agent's Report with respect to its taxable year ended December 31, 1958. Among other adjustments, such Report erroneously reduced Plaintiff's allowable percentage depletion deduction for 1958 by the amount of $159,475.09.

(g) Based upon the findings contained in such Revenue Agent's Report, the then Commissioner of Internal Revenue made the following additional assessments of income tax and interest thereon:

Tax	Interest
$80,790.14	$16,019.68

(h) Plaintiff paid such additional assessment of income tax on July 5, 1962, and interest thereon was paid on September 4, 1962, to the District Director of Internal Revenue, Oklahoma City District.

(i) On July 2, 1964, Plaintiff filed with the District Director of Internal Revenue, Oklahoma City District, a Claim For Refund (Form 843) for overpayment of in-

come tax for its taxable year ended December 31, 1958, in the amount of $80,790.14, or such further amount as may be legally refundable, together with statutory interest thereon. Such Claim For Refund alleged that the Commissioner erred in reducing Plaintiff's 1958 percentage depletion allowance by the amount of $159,475.09.

(j) On January 21, 1965, Plaintiff was notified by the District Director of Internal Revenue, Oklahoma City District, that its Claim For Refund in the amount of $80,790.14 had been disallowed.

(k) Under date of March 23, 1965, Plaintiff filed with the District Director of Internal Revenue, Oklahoma City District, an executed Waiver Of Statutory Notification Of Claim Disallowance (Form 2297).

(l) Inasmuch as more than six months have expired since the filing of Plaintiff's Claim For Refund, Plaintiff brings this action for its taxable year ended December 31, 1958 pursuant to the provisions of Section 6532(a) of the Internal Revenue Code of 1954.

VII. Section 1341 of the Internal Revenue Code of 1954 sets forth the mandatory provisions which govern the computation of tax for a taxable year in which a taxpayer is required to restore a substantial amount which had been included in its gross income in prior taxable years because it was received under a claim of right without restrictions as to its use. Pursuant to Section 1341(a) of the Internal Revenue Code of 1954, the tax for the taxable year in which such restoration is required shall be the lesser of:

(a) The tax for such taxable year with the amount required to be restored treated as a deduction as computed under Section 1341(a)(4) of the Internal Revenue Code of 1954; or

(b) The tax for such taxable year without the amount required to be restored treated as a deduction, minus the decrease in tax for the prior taxable years which would result solely from the exclusion of the amount required to be restored from gross income for such prior taxable years as computed under Section 1341(a)(5) of the Internal Revenue Code of 1954.

VIII, (a) Computation of Plaintiff's tax for its taxable year ended December 31, 1958, under the provisions of Section 1341(a)(4) of the Internal Revenue Code of 1954 produces a tax of $5,214,864.42.

(b) Computation of Plaintiff's tax for its taxable year ended December 31, 1958 under the provisions of Section 1341(a)(5) of the Internal Revenue Code of 1954 produces a tax of $5,214,864.42.

(c) Inasmuch as Plaintiff's tax for its taxable year ended December 31, 1958 under subparagraph (b) of this paragraph is not less than the tax under subparagraph (a) of this paragraph, the tax for such year is to be computed under subparagraph (a) of this paragraph.

IX. Plaintiff has overpaid its tax for the taxable year ended December 31, 1958 in the amount of $82,927.05, which, together with interest assessed and collected thereon in the amount of $16,019.68, constitutes an aggregate overpayment of $98,946.73.

X. (a) In determining Plaintiff's Federal income tax liability for the taxable year ended December 31, 1958, the Commissioner erroneously failed to apply the provisions of Section 1341 of the Internal Revenue Code of 1954 to determine the effect thereon of the $505,536.54 which Plaintiff was required to restore during such year.

(b) More particularly, the Commissioner erroneously failed to compute the tax effect, for Plaintiff's taxable year ended December 31, 1958, of the $505,536.54 which Plaintiff was required to restore during such year under the provisions of Section 1341(a)(4) of the Internal Revenue Code of 1954.

(c) More particularly, in the event the Commissioner attempted to apply the provisions of Section 1341 of the Internal Revenue Code of 1954 to determine the effect on Plaintiff's Federal income tax liability of the $505,536.54 which Plaintiff was required to restore during such year, his application thereof was erroneous in that he reduced Plaintiff's allowable percentage depletion deduction for the taxable year ended December 31, 1958 in the amount of $159,475.09.

(d) In determining Plaintiff's Federal income tax liability for its taxable year ended December 31, 1958, the

Commissioner erroneously reduced its allowable percentage depletion deduction by the amount of $159,475.09.

(e) The actions of the Commissioner enumerated in subparagraphs (a), (b), (c), and (d) of this paragraph were erroneous, illegal and without warrant in law.

XI. By reason of the facts set forth in this Complaint, there is due and owing from Defendant to Plaintiff the amount of $96,809.82, or such further amount as this Court may find due and owing from Defendant to Plaintiff, with interest thereon as provided by law. Such amount of $96,809.82 was erroneously and illegally collected from Plaintiff for its taxable year ended December 31, 1958.

XII. Although repayment of the said amount of $96,809.82 has been demanded, no part thereof has been credited, remitted, refunded or repaid to Plaintiff or to anyone on Plaintiff's account.

XIII. Wherefore, Plaintiff demands judgment against Defendant in the principal amount of $96,809.82, or such further amount as this Court may find to be legally due and owing by Defendant to Plantiff, together with interest thereon as provided by law.

ROBERT J. CASEY
DONALD P. MOYERS

Of Counsel:

CLARK, CARR & ELLIS

Filed May 12, 1965.

ANSWER

The defendant, United States of America, by its attorney, John M. Imel, United States Attorney for the Northern District of Oklahoma, for its answer to the complaint herein, alleges as follows:

I. Admits the allegations contained in paragraph I.

II. Admits the allegations contained in paragraph II, except alleges that it is without knowledge or information sufficient to form a belief as to the truth of the alle-

gation that plaintiff's principal office is at 1437 South Boulder, Tulsa, Oklahoma.

III. Admits the allegations contained in Paragraph III, except denies that the plaintiff has overpaid its tax for the year ended December 31, 1958, or that any sum is legally refundable to it.

IV. Alleges that it is without knowledge or information sufficient to form a belief as to the truth of the allegations contained in paragraph IV, except admits that the plaintiff filed its return on a calendar year basis during the year in question.

V. Alleges that it is without knowledge or information sufficient to form a belief as to the truth of the allegations contained in paragraph V(a) through (d), except to allege that the plaintiff's 1952 through 1958 federal income tax returns speak for themselves.

VI. (a) Admits the allegations contained in paragraph VI(a).

(b) Admits that the plaintiff's federal income tax return for 1958 reflected a tax due thereon in the amount of $5,214,382.49. Alleges that it is without knowledge or information sufficient to form a belief as to the truth of the remaining allegations contained in paragraph VI(b), and further alleges said tax return speaks for itself.

(c) Admits the allegations contained in paragraph VI(c).

(d) Admits the allegations contained in paragraph VI(d).

(e) Admits the allegations contained in paragraph VI(e).

(f) Alleges that it is without knowledge or information sufficient to form a belief as to the truth of the allegations contained in paragraph VI(f), except denies that the plaintiff's allowable depletion deduction for 1958 was erroneously reduced.

(g) Admits that additional assessments were made against the plaintiff in the amounts alleged, but alleges that it is without knowledge or information sufficient to form a belief as to the truth of the remaining allegations contained in paragraph VI(g).

(h) Admits the allegations contained in paragraph VI(h).

(i) Alleges that it is without knowledge or information sufficient to form a belief as to the truth of the allegations contained in paragraph VI(i), except admits the allegations contained in the first sentence thereof, and further alleges that said claim for refund speaks for itself.

(j) Denies the allegations contained in paragraph VI(j).

(k) Admits the allegations contained in paragraph VI(k).

(l) Admits the allegations contained in paragraph VI(l).

VII. Alleges that is is neither required to admit or deny the allegations contained in paragraph VII(a) and (b), as said allegations are purely questions of law, and further alleges that Section 1341(a) of the Internal Revenue Code of 1954 speaks for itself.

VIII. (a) Alleges that it is without knowledge or information sufficient to form a belief as to the truth of the allegations contained in paragraph VIII(a), and further alleges that any computation of the plaintiff's income tax liability speaks for itself.

(b) Alleges that it is without knowledge or information sufficient to form a belief as to the truth of the allegations contained in paragraph VIII(b), and further alleges that any computation of the plaintiff's income tax liability speaks for itself.

(c) Denies the allegations contained in paragraph VIII(c).

IX. Denies the allegations contained in paragraph IX.

X. Denies the allegations contained in paragraph X (a), (b), (c), (d), and (e), except admits that the defendant reduced the depletion deduction claimed by the defendant by the sum of $159,475.09.

XI. Denies the allegations contained in paragraph XI.

XII. Admits the allegations contained in paragraph XII.

Wherefore, the defendant prays that judgment be entered dismissing with prejudice the plaintiff's complaint

and allowing the defendant its costs and disbursements, and for such other and further relief as to the Court may appear just and proper.

LAWRENCE H. MCLOUD
Assistant United States Attorney

Filed July 8, 1965.

JOINT STIPULATION OF FACTS

It is hereby stipulated by and between the parties to this proceeding that the facts herein set forth are true, and may be considered as evidence in this case, subject to objection as to their relevance or materiality, and further subject to the right of either party hereto to adduce further evidence at the trial of this proceeding not inconsistent with the facts hereinafter set forth.

1. Plaintiff, at all times pertinent hereto, was a corporation duly organized and existing under the laws of the State of Delaware, and maintained its principal office at 1437 South Boulder, Tulsa, Oklahoma.

2. Jurisdiction to hear and determine this action is conferred upon this Court by Title 28, United States Code, Section 1346(a)(1).

3. This action is brought for the recovery of $96,809.82, representing Federal income tax collected from the plaintiff for the taxable year ended December 31, 1958 (hereinafter referred to as the taxable year), or such further amount, if any, as may be legally refundable together with statutory interest thereon.

4. The only issue presented to this Court for decision herein is whether, in computing plaintiff's liability for federal income tax for the taxable year ending December 31, 1958 under the provisions of Section 1341(a)(4) of the 1954 Internal Revenue Code, it was proper to reduce its otherwise allowable percentage depletion for the taxable year by $139,022.55, representing 27½ percent of $505,536.54, the purchase price received by it from the sale of natural gas during prior taxable years, which purchase price had been included by it in gross income for such prior taxable years under a claim of right with-

out restriction as to use, and which it was required to restore to the payors thereof during the taxable year ending December 31, 1958; or, in the alternative, whether plaintiff is required to reduce its otherwise allowable deduction under Section 1341(a)(4) of $505,536.54 by 27½ percent, or $139,022.55, to reflect percentage depletion previously claimed and allowed thereon in its federal income tax returns for the years in which such amount was taken into gross income under a claim of right without restriction as to use.

5. At all times pertinent hereto, plaintiff has kept its books and filed its federal income tax returns on the accrual basis, utilizing a calendar year.

6. (a) Under date of September 14, 1959 plaintiff timely filed its 1958 federal income tax return, which showed a liability for tax of $5,214,382.49.

(b) Said tax liability of $5,214,382.49 was paid by plaintiff on the dates and in the amounts set forth below to the District Director of Internal Revenue, Oklahoma City District:

Date of Payment	Amount of Payment
10/13/58	$ 880,000.00
12/12/58	1,000,000.00
3/12/59	2,018,904.10
6/12/59	1,315,478.39
	$5,214,382.49

(c) On or about September 25, 1961, plaintiff filed an amended federal income tax return for its taxable year ended December 31, 1958, which reflected an additional tax due for such year in the amount of $2,618.84.

(d) Plaintiff paid said additional tax of $2,618.84, together with interest thereon of $397.13 on or about September 25, 1961 to the District Director of Internal Revenue, Oklahoma City District.

7. (a) Under date of July 6, 1962, plaintiff received from the District Director of Internal Revenue, Oklahoma City District, a revenue agent's report, dated July 5, 1962, with respect to its taxable year ended December 31, 1958.

(b) Said report proposed certain adjustments to plaintiff's income for the taxable year, and further proposed a net deficiency in income tax for the taxable year in the amount of $80,790.14.

(c) Pursuant to this report, the then Commissioner of Internal Revenue made an additional assessment of income tax of $80,790.14 and interest thereon of $16,019.68 for the taxable year.

(d) Plaintiff paid such additional assessment of income tax on July 5, 1962, and interest thereon was paid September 4, 1962 to the District Director of Internal Revenue, Oklahoma City District.

8. (a) On July 2, 1964, plaintiff filed with the District Director of Internal Revenue, Oklahoma City District, a claim for refund for the overpayment of income tax for its taxable year ended December 31, 1958, in the amount of $80,790.14, or such further amount, if any, as might be legally refundable, together with statutory interest thereon. Such claim for refund alleged that Commissioner erred in reducing plaintiff's 1958 percentage depletion allowance by the amount of $159,475.09.

(b) On January 21, 1965, plaintiff was notified that the District Director of Internal Revenue, Oklahoma City District, proposed to disallow said claim for refund.

(c) Under date of March 23, 1965, plaintiff filed with the District Director of Internal Revenue, Oklahoma City District, a waiver of statutory notification of claim disallowance with respect to said claim for refund.

(d) No action or suit has been commenced or is pending in any other court on account of this claim for refund. Plaintiff is the owner of such claim for refund, and no assignment or transfer of legal title thereto has been made.

9. (a) At all times, material hereto, plaintiff was an independent producer of natural gas, engaged in the sale thereof pursuant to rates established or approved by the Oklahoma Corporation Commission and/or the Federal Power Commission. As such, it owned and operated certain oil and gas leases in the Guymon-Hugoton Gas Field located in the States of Kansas, Oklahoma, and Texas (hereafter referred to as the Hugoton Field.)

(b) Under gas purchase contracts dated August 28, 1945, plaintiff commenced making sales of gas produced from certain of its interests in the Hugoton Field in Texas County, Oklahoma to Cities Service Gas Company (hereafter referred to as Cities Service.).

(c) Immediately prior to August 1, 1952, the price being paid by Cities Service to plaintiff pursuant to these agreements for all gathered and wellhead gas purchases was 8.4863 cents per Mcf when computed on a pressure base of 14.65 psia (per square inch absolute).

(d) In addition to the August 28, 1945 gas purchase contracts, plaintiff sold and delivered natural gas to Cities Service at the wellhead under certain joint operating agreements covering other of plaintiff's interests in the Hugoton Field in Texas County, Oklahoma, where Cities Service was denominated as the Gas Operator.

(e) Immediately prior to August 1, 1952, the price being paid by Cities Service to plaintiff pursuant to such joint operating agreements for the gas sold and delivered thereunder was 8.9329 cents per Mcf (14.65 psia).

(f) On July 29, 1952 the Corporation Commission of the State of Oklahoma, by Order effective August 1, 1952, determined that no gas could be produced from any well in the Guymon-Hugoton Field, Texas County, Oklahoma, except at a price not less than 9.8262 cents per Mcf (14.65 psia) if sold at the wellhead, or, if not sold at the wellhead, at a price equivalent to not less than 9.8262 cents per Mcf (14.65 psia) plus the reasonable cost of gathering.

(g) On and after the effective date of this Order, plaintiff was required to charge, and did charge, and Cities Service was required to pay, and did pay, an additional 1.3399 cents per Mcf (14.65 psia) for sales and purchases under the August 28, 1945 gas purchase contracts, and an additional .8933 cents per Mcf (14.65 psia) for sales and purchases under the joint operating agreements.

10. (a) On March 20, 1958, the Supreme Court of Oklahoma, pursuant to Mandate of the Supreme Court of the United States in the proceeding Michigan-Wisconsin Pipeline Co., et al. v. Corporation Commission of

Oklahoma, 355 U.S. 425 (1958), issued an Order and Mandate, vacating the Oklahoma Minimum Price Order in its entirety. On March 27, 1958, the Supreme Court of the State of Oklahoma issued a similar order vacating the Oklahoma Minimum Price Order in its entirety in the proceeding commenced by Cities Service which was then pending before it on stipulation.

(b) On or about April 8, 1958, Cities Service filed a complaint in the Superior Court of New Castle County, Delaware (Civil Action No. 370), wherein it alleged that plaintiff was indebted to it in the principal sum of $777,853.25, representing alleged overcharges for gas purchased from plaintiff by Cities Service during the period commencing August 1, 1952 through and including December 22, 1957. As the basis for its complaint, Cities Service alleged that during the aforesaid period it had made purchases from plaintiff of natural gas in the Hugoton Field, paying the minimum price required by the Oklahoma Minimum Price Order, and further alleged that the invalidation of this Order ab initio by the Oklahoma Supreme Court entitled it to a refund of all amounts in excess of the amounts which it was contractually obligated to pay to plaintiff during the period commencing August 1, 1952 through and including December 22, 1957.

(c) On September 10, 1958, Cities Service proposed to plaintiff a compromise settlement agreement with respect to such litigation, wherein it agreed to terminate the controversy upon the payment by plaintiff to Cities Service of the sum of $500,000. This proposal was conditioned upon the acceptance by the Federal Power Commission of certain amendments to the gas purchase contracts of August 28, 1945. Plaintiff accepted and agreed to this settlement on October 6, 1958.

(d) On November 5, 1958, the Federal Power Commission formally accepted the aforementioned amendments to the 1945 contracts between the parties.

(e) Concurrent with such acceptance, plaintiff was required to refund and repay to Cities Service the aggregate amount of $500,000 in settlement of the litigation commenced against it by said Cities Service.

(f) On December 8, 1958, by order of the Superior Court of New Castle County, Delaware, Cities Service,

Civil Action No. 370 was dismissed upon stipulation of the parties with prejudice.

(g) The entire $500,000 which plaintiff was required to restore to Cities Service during the taxable year had been included in plaintiff's gross income for federal income tax purposes during the taxable years 1952 through 1957, inclusive, because plaintiff had an unrestricted right thereto in the following amounts:

Taxable year ended December 31	Amount Included In Plaintiff's Gross Income
1957	$ 67,668.17
1956	93,094.52
1955	93,018.88
1954	120,064.70
1953	91,972.49
1952	34,181.24
	$500,000.00

The above stated amounts were included in plaintiff's gross income from the property in each of the respective years for the purposes of computing plaintiff's depletion allowance at the rate of 27½ percent, pursuant to the provisions of Section 613, Internal Revenue Code of 1954, and said amounts were included in gross income in each of such respective years. In determining plaintiff's taxable income for each of such respective years, upon which federal income taxes were assessed and paid, said percentage depletion which was claimed and allowed at the rate of 27½ percent of the above stated amounts, and other deductions, was deducted from the amounts included in plaintiff's gross income as above stated.

11. (a) In addition to the operating interests set forth above, plaintiff owned certain other mineral interests in the Hugoton Field, which were operated for it by the Dorchester Corporation (hereinafter referred to as Dorchester).

(b) At all times, material hereto, Dorchester was an independent producer of natural gas in Oklahoma. On July 1, 1954, Dorchester commenced sales of natural gas for plaintiff's account to Natural Gas Pipeline Company of America (hereinafter referred to as Natural) at 9.8262 cents per Mcf (14.65 psia), the then existing mini-

mum price established by the Oklahoma Corporation Commission's Order of July 29, 1952.

(c) Commencing July 1, 1954, Dorchester collected and paid over to plaintiff 9.8262 cents per Mcf (14.65 psia) on account of all gas sold by it to Natural from plaintiff's interests.

(d) As the result of litigation commenced by Natural, and as the result of the invalidation of the Oklahoma Minimum Price Order, as more fully set forth above, it was ultimately determined that the proper contractual price for natural gas sold and delivered by Dorchester to Natural from July 1, 1954 was 6.253 cents per Mcf (14.65 *psia*).

(e) Accordingly, Dorchester was required to refund to Natural all charges in excess of 6.253 cents per Mcf for gas sold by it to Natural, including gas sold by it as Operator for plaintiff's account.

(f) On September 26, 1958, Dorchester by formal notice demanded reimbursement from plaintiff of so much of the overcharge as was attributable to plaintiff's interest, or $5,536.54, stating in part:

"We must, of course, now recover from you the overpayment just as Natural is recovering it from us. There is no question of our legal right to do this, for the United States Court of Appeals has in effect ruled that we should have been paid at the contract rate all along by Natural, and in turn payments to your interest should have been made at the contract rate."

(g) On October 22, 1958, plaintiff restored and refunded to Dorchester the entire $5,536.54.

(h) The entire $5,536.54 which plaintiff was required to restore to Dorchester during the taxable year had been included in plaintiff's gross income for federal income tax purposes during the taxable years 1954 through 1957, inclusive, because plaintiff had an unrestricted right thereto, in the following amounts:

Taxable Year Ended December 31	Amount Included In Plaintiff's Gross Income
1957	$1,276.07
1956	1,406.23
1955	1,810.53
1954	1,043.71
	$5,536.54

The above stated amounts were included in plaintiff's gross income from the property in each of the respective years for the purposes of computing plaintiff's depletion allowance at the rate of 27½ percent, pursuant to the provisions of Section 613, Internal Revenue Code of 1954, and said amounts were included in gross income in each of such respective years. In determining plaintiff's taxable income for each of such respective years, upon which federal income taxes were assessed and paid, said percentage depletion which was claimed and allowed at the rate of 27½ percent of the above stated amounts, and other deductions, was deducted from the amounts included in plaintiff's gross income as above stated.

12. (a) In addition to the amounts which plaintiff was required to restore to Cities Service and Dorchester during the taxable year as set forth above, plaintiff was required to make similar restorations to Kansas-Nebraska Natural Gas Company, Northern Natural Gas Company, Interstate Gas Company, and the Texas Company. These restorations were required to be made by plaintiff during the taxable years in the amounts as set forth below:

Restored to	Amount of Restoration	Restoration Required To Be Made In Taxable Year Ending December 31
Kansas-Nebraska Natural Gas Company	$53,673.80	1959
Interstate Gas Company	3,765.96	1960
Northern Natural Gas Co.	2,498.63	1961
The Texas Company	62,210.79	1961

13. (a) On its federal income tax return for the taxable year plaintiff deducted $505,536.54, which it was re-

quired to restore during such year to Cities Service and Dorchester as more fully set forth above.

(b) On its federal income tax return for the taxable year ending December 31, 1959, plaintiff deducted $53,673.80, which it was required to restore to Kansas-Nebraska Natural Gas Company during such year.

(c) On its federal income tax return for the taxable year ending December 31, 1960, plaintiff deducted $3,765.96, which it was required to restore to Interstate Gas Company during such year.

(d) On its federal income tax return for the taxable year ending December 31, 1961, plaintiff deducted $2,498.63 and $62,210.79, which it was required to restore to Northern Natural Gas Company and the Texas Company, respectively, during such year.

14. So far as material hereto, the audit of plaintiff's federal income tax return for the taxable year resulted in the reduction of its otherwise allowable percentage depletion for the taxable year by $159,475.09, representing 27½ percent of the following:

(a) The amount of $452,861.82 with respect to the Cities Service restoration.

(b) The amount of $4,898.43 with respect to the Dorchester restoration.

(c) The amount of $53,673.80 which it was required to restore to Kansas-Nebraska Natural Gas Company during the taxable year ending December 31, 1959.

(d) The amount of $3,765.96 which plaintiff was required to restore to Interstate Gas Company during the taxable year ending December 31, 1960.

(e) The amounts of $2,498.63 and $62,210.79 which Plaintiff was required to restore to Northern Natural Gas Company and The Texas Company, respectively, during the taxable year ending December 31, 1961.

15. (a) Apart from the issue remaining before this Court for decision, Plaintiff is entitled to judgment for recovery of tax in the amount of $17,468.76, plus assessed interest in the amount of $3,463.88, a total of $20,932.64, plus statutory interest thereon, as provided by law, from the respective dates of payment of July 5, 1962,

with respect to the tax, and September 4, 1962, with respect to the interest assessed thereon.

(b) Any additional amount due the Plaintiff, if any, under this Court's decision will be computed by the parties and presented to this Court for the entry of judgment.

ROBERT J. CASEY
For Plaintiff
JOHN M. IMEL
JOHN O. JONES
For Defendant

Dated: September —, 1965.

Filed October 1, 1965.

FINDINGS OF FACT, CONCLUSIONS OF LAW AND DECISION

This case has been submitted to the Court for decision on the merits on a Joint Stipulation of Facts and the briefs of both parties.

ISSUE

The issue for determination herein is stated alternatively in the Joint Stipulation of Facts as follows:

"The only issue presented to this Court for decision herein is whether, in computing plaintiff's liability for federal income tax for the taxable year ending December 31, 1958 under the provisions of Section 1341(a)(4) of the 1954 Internal Revenue Code, it was proper to reduce its otherwise allowable percentage depletion for the taxable year by $139,022.55 representing 27½ percent of $505,536.54, the purchase price received by it from the sale of natural gas during prior taxable years, which purchase price had been included by it in gross income for such prior taxable years under a claim of right without restriction as to use, and which it was required to restore to the payors thereof during the taxable year ending December 31, 1958; or, in the alternative, whether plaintiff is required to reduce its otherwise allowable de-

duction under Section 1341(a)(4) of $505,536.54 by 27½ percent, or $139,022.55, to reflect percentage depletion previously claimed and allowed thereon in its federal income tax returns for the years in which such amount was taken into gross income under a claim of right without restriction as to use."

FINDINGS OF FACT

The following Findings of Fact are pertinent to the issue and are made herein:

1. This action is brought for the recovery of $96,809.82, representing Federal income tax collected from plaintiff for the taxable year ended December 31, 1958, or such further amount, if any, as may be legally refundable together with statutory interest thereon.

2. (a) At all times, material hereto, plaintiff was an independent producer of natural gas, engaged in the sale thereof pursuant to rates established or approved by the Oklahoma Corporation Commission and/or the Federal Power Commission. As such, it owned and operated certain oil and gas leases in the Guymon-Hugoton Gas Field located in the States of Kansas, Oklahoma, and Texas (hereafter referred to as the Hugoton Field).

(b) Under gas purchase contracts dated August 28, 1945, plaintiff commenced making sales of gas produced from certain of its interests in the Hugoton Field in Texas County, Oklahoma to Cities Service Gas Company (hereafter referred to as Cities Service).

(c) Immediately prior to August 1, 1952, the price being paid by Cities Service to plaintiff pursuant to these agreements for all gathered and wellhead gas purchases was 8.4863 cents per Mcf when computed on a pressure base of 14.65 psia (per square inch absolute).

(d) In addition to the August 28, 1945 gas purchase contracts, plaintiff sold and delivered natural gas to Cities Service at the wellhead under certain joint operating agreements covering other of plaintiff's interests in the Hugoton Field in Texas County, Oklahoma, where Cities Service was denominated as the Gas Operator.

(e) Immediately prior to August 1, 1952, the price being paid by Cities Service to plaintiff pursuant to such

joint operating agreements for the gas sold and delivered thereunder was 8.9329 cents per Mcf (14.65 psia).

(f) On July 29, 1952 the Corporation Commission of the State of Oklahoma, by Order effective August 1, 1952, determined that no gas could be produced from any well in the Hugoton Field, Texas County, Oklahoma, except at a price not less than 9.8262 per Mcf (14.65 psia) if sold at the wellhead, or, if not sold at the wellhead, at a price equivalent to not less than 9.8262 cents per Mcf (14.65 psia) plus the reasonable cost of gathering.

(g) On and after the effective date of this Order, plaintiff was required to charge, and did charge, and Cities Service was required to pay, and did pay, an additional 1.3399 cents per Mcf (14.65 psia) for sales and purchases under the joint operating agreements.

3. (a) On March 20, 1958, the Supreme Court of Oklahoma, pursuant to Mandate of the Supreme Court of the United States in the proceeding Michigan-Wisconsin Pipeline Co., et al. v. Corporation Commission of Oklahoma, 355 U.S. 425 (1958), issued an Order and Mandate, vacating the Oklahoma Minimum Price Order in its entirety. On March 27, 1958, the Supreme Court of the State of Oklahoma issued a similar order vacating the Oklahoma Minimum Price Order in its entirety in the proceeding commenced by Cities Service which was then pending before it on stipulation.

(b) On or about April 8, 1958, Cities Service filed a complaint in the Superior Court of New Castle County, Delaware, (Civil Action No. 370), wherein it alleged that plaintiff was indebted to it in the principal sum of $777,853.25, representing alleged overcharges for gas purchased from plaintiff by Cities Service during the period commencing August 1, 1952 through and including December 22, 1957. As the basis for its complaint, Cities Service alleged that during the aforesaid period it had made purchases from plaintiff of natural gas in the Hugoton Field, paying the minimum price required by the Oklahoma Minimum Price Order, and further alleged that the invalidation of this Order ab initio by the Oklahoma Supreme Court entitled it to a refund of all amounts in excess of the amounts which it was contractually obligated to pay

to plaintiff during the period commencing August 1, 1952 through and including December 22, 1957.

(c) On September 10, 1958, Cities Service proposed to plaintiff a compromise settlement agreement with respect to such litigation, wherein it agreed to terminate the controversy upon the payment by plaintiff to Cities Service of the sum of $500,000.00. This proposal was conditioned upon the acceptance by the Federal Power Commission of certain amendments to the gas purchase contracts of August 28, 1945. Plaintiff accepted and agreed to this settlement on October 6, 1958.

(d) On November 5, 1958, the Federal Power Commission formally accepted the aforementioned amendments to the 1945 contracts between the parties.

(e) Concurrent with such acceptance, plaintiff was required to refund and repay to Cities Service the aggregate amount of $500,000 in settlement of the litigation commenced against it by said Cities Service.

(f) On December 8, 1958, by order of the Superior Court of New Castle County, Delaware, Cities Service, Civil Action No. 370 was dismissed upon stipulation of the parties with prejudice.

(g) The entire $500,000.00 which plaintiff was required to restore to Cities Service during the taxable year had been included in plaintiff's gross income for federal income tax purposes during the taxable years 1952 through 1957, inclusive, because plaintiff had an unrestricted right thereto in the following amounts:

Taxable year ended December 31	Amount Included in Plaintiff's Gross Income
1957	$ 67,668.17
1956	93,094.52
1955	93,018.88
1954	120,064.70
1953	91,972.49
1952	34,181.24
	$500,000.00

The above stated amounts were included in plaintiff's gross income from the property in each of the respective years for the purposes of computing plaintiff's depletion allowance therefrom at the rate of 27½ percent, pursuant

to the provisions of Section 613, Internal Revenue Code of 1954, and said amounts before the depletion allowances were taken were included in gross income in each of such respective years. In determining plaintiff's taxable income for each of such respective years, upon which federal income taxes were assessed and paid, said percentage depletion which was claimed and allowed at the rate of 27½ percent of the above stated amounts, and other deductions, was deducted from the amounts included in plaintiff's gross income as above stated.

4. (a) In additions to the operating interests set forth above, plaintiff owned certain other mineral interests in the Hugoton Field, which were operated for it by the Dorchester Corporation (hereinafter referred to as Dorchester.)

(b) At all times, material hereto, Dorchester was an independent producer of natural gas in Oklahoma. On July 1, 1954, Dorchester commenced sales of natural gas for plaintiff's account to Natural Gas Pipeline Company of America (hereinafter referred to as Natural) at 9.8262 cents per Mcf (14.65 psia), the then existing minimum price established by the Oklahoma Corporation Commission's Order of July 29, 1952.

(c) Commencing July 1, 1954, Dorchester collected and paid over to plaintiff 9.8262 cents per Mcf (14.65 psia) on account of all gas sold by it to Natural from plaintiff's interests.

(d) As the result of litigation commenced by Natural, and as the result of the invalidation of the Oklahoma Minimum Price Order, as more fully set forth above, it was ultimately determined that the proper contractual price for natural gas sold and delivered by Dorchester to Natural from July 1, 1954 was 6.253 cents per Mcf (14.65 psia).

(e) Accordingly, Dorchester was required to refund to Natural all charges in excess of 6.253 cents per Mcf for gas sold by it to Natural, including gas sold by it as Operator for plaintiff's account.

(f) On September 26, 1958, Dorchester by formal notice demanded reimbursement from plaintiff of so much of the overcharge as was attributable to plaintiff's interest, or $5,536.54, stating in part:

"We must, of course, now recover from you the overpayment just as Natural is recovering it from us. There is no question of our legal right to do this, for the United States Court of Appeals has in effect ruled that we should have been paid at the contract rate all along by Natural, and in turn payments to your interest should have been made at the contract rate."

(g) On October 22, 1958, plaintiff restored and refunded to Dorchester the entire $5,536.54.

(h) The entire $5,536.54 which plaintiff was required to restore to Dorchester during the taxable year had been included in plaintiff's gross income for federal income tax purposes during the taxable years 1954 through 1957, inclusive, because plaintiff had an unrestricted right thereto, in the following amounts:

Taxable Year Ended December 31	Amount Included In Plaintiff's Gross Income
1957	$1,276.07
1956	1,406.23
1955	1,810.53
1954	1,043.71
	$5,536.54

The above stated amounts were included in plaintiff's gross income from the property in each of the respective years for the purposes of computing plaintiff's depletion allowance therefrom at the rate of 27½ percent, pursuant to the provisions of Section 613, Internal Revenue Code of 1954, and said amounts before the depletion allowances were taken were included in gross income in each of such respective years. In determining plaintiff's taxable income for each of such respective years, upon which federal income taxes were assessed and paid, said percentage depletion which was claimed and allowed at the rate of 27½ percent of the above stated amounts, and other deductions, was deducted from the amounts included in plaintiff's gross income as above stated.

5. In its Federal income tax return for the taxable year 1958, plaintiff deducted the entire $505,536.54 which it was required to restore and repay to both Cities Service and Dorchester in such year. Upon audit by the Govern-

ment certain adjustments were made to plaintiff's income for the taxable year 1958, including the reduction of its otherwise allowable percentage depletion allowance for such taxable year in the amount of $139,022.55, representing 27½ percent of the $505,536.54 which it was required to restore and repay to Cities Service and Dorchester during the taxable year 1958. These adjustments resulted in an additional assessment of tax for the taxable year, which was paid by plaintiff, together with interest thereon. Thereupon, plaintiff filed a timely claim for refund of such tax on the grounds that its otherwise allowable percentage depletion allowance for the taxable year had been erroneously reduced by 27½ percent of the amount which it was required to restore and repay to both Cities Service and Dorchester. This claim was not allowed, and the instant suit for refund was timely commenced.

6. The meaning of Title 26, United States Code, Section 1341, is not clear when applied to the issue herein.

7. At all times pertinent hereto, plaintiff has kept its books and filed its Federal income tax returns on the accrual basis, utilizing a calendar year.

8. Completely apart from the issue herein the defendant has stipulated that plaintiff is entitled to judgment for recovery of tax related to other similar matters in the amount of $17,468.76, plus assessed interest in the amount of $3,463.88, a total of $20,932.64, plus statutory interest thereon, as provided by law, from the respective dates of payment of July 5, 1962, with respect to the tax, and September 4, 1962, with respect to the interest assessed thereon.

CONCLUSIONS OF LAW

1. (a) The Court has jurisdiction of this action under 28 U.S.C. 1346(a)(1).

(b) The plaintiff has paid the tax in full for the taxable period involved herein.

(c) The plaintiff has made a timely claim for refund. Sections 7422(a), 6511(b)(1) of the Internal Revenue Code of 1954.

(d) More than six months have expired since the filing of plaintiff's claim for refund and plaintiff brings this

timely action for its taxable year ended December 31, 1958 pursuant to the provisions of Section 6532(a) of the Internal Revenue Code of 1954.

2. No action or suit has been commenced or is pending in any other Court on account of this claim for refund. Plaintiff is the owner of such claim for refund, and no assignment or transfer of legal title thereto has been made.

3. Plaintiff, at all times pertinent hereto, was a corporation duly organized and existing under the laws of the State of Delaware and maintained its principal office in Tulsa, Oklahoma.

4. An interpretation is required of Title 26, United States Code, Section 1341, which in pertinent parts reads as follows:

"Sec. 1341. Computation Of Tax Where Taxpayer Restores Substantial Amount Held Under Claim Of Right.

(a) General Rule.—if—

(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;

(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

(3) the amount of such deduction exceeds $3,000, then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

(4) the tax for the taxable year computed with such deduction; or

(5) an amount equal to—

(A) the tax for the taxable year computed without such deduction, minus

(B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years)."

5. The parties have stipulated that the computation of tax liability herein should be under Section 1341(a)(4)

and not (a)(5). This is because the tax rate herein would be 52% in all events.

6. The general purpose of Section 1341 is to allow a taxpayer who has included certain income under a claim of right in his gross income for a prior year to receive adequate and fair tax benefits in the year in which the taxpayer has been required to restore or repay such income. This purpose is set forth by the said enactment of Congress in general terms without specific provisions being made for all types of income. Thus, it becomes necessary to interpret Section 1341 and ascertain the intent of Congress when it is applied as herein to income included in gross income which possesses the right to a depletion allowance to be thereafter taken and the subsequent deduction which is to be allowed in the taxable year when such income must be restored or repaid.

7. General rules of statutory construction apply to the construction of tax status. Where the meaning of a statute is clear, the statute must be enforced as written. United States v. Martin, 337 F.2d 171 (Eighth Cir. 1964).

8. Where court is in doubt as to meaning of statute, it is entitled to look to purpose behind it. Stanley v. C. I. R., 338 F.2d 434 (Ninth Cir. 1964).

9. It is well settled that legislative history, generally speaking, may be resorted to as an aid in determining the proper construction of a statute which is ambiguous or of doubtful meaning. Annot: 70 A.L.R. 5.

10. In the interpretation of statutes, the function of the courts is to construe the language so as to give effect to the intent of Congress. There is no invariable rule for the discovery of that intention. To take a few words from their context and with them thus isolated to attempt to determine their meaning, certainly would not contribute greatly to the discovery of the purpose of the draftsmen of a statute, particularly in a law drawn to meet many needs of a major occupation. United States v. American Trucking Associations, 310 U.S. 534, 84 L.Ed. 1345, 60 S.Ct. 1044 (1940).

11. The most persuasive evidence of the purpose of a statute is the words by which the Congress undertook to give expression to its wishes. If these words are sufficient in and of themselves to determine the purpose of the legis-

lation their plain meaning should be followed. However, when this meaning leads to absurd or futile results the Court must look beyond the words to the purpose of the act. If the plain meaning does not produce an absurd result but merely an unreasonable one plainly at variance with the policy of the legislation as a whole the Court should follow that purpose, rather than the literal words. When aid to construction of the meaning of words as used in the statute, is available, there certainly can be no "rule of law" which forbids its use, however clear the words may appear on "superficial examination." The interpretation of the meaning of statutes, as applied to justiciable controversies, is exclusively a judicial function. Emphasis should be laid upon the necessity for appraisal of the purposes as a whole of Congress in analyzing the meaning of clauses or sections of general acts. A few words of general connotation appearing in the text of statutes should not be given a wide meaning, contrary to a settled policy except when a different purpose is plainly shown. United States v. American Trucking Associations, supra.

12. Section 1341 did not create a new deduction but was enacted to provide relief from the ruling in United States v. Lewis, 340 U.S. 590, 95 L.Ed. 560, which held it mandatory that the taxpayer take a deduction in the year of repayment even though the tax benefit to be derived therefrom might be substantially less than the liability incurred from including the returned income in the year of receipt. National Life & Accident Insurance Company v. United States, 244 F. Supp. 135.

13. It is concluded that it was the intent of Congress that if an item (income) included in gross income by a taxpayer per Section 1341(a)(1) was to thereafter be subject to a depletion allowance for tax purposes that if such taxpayer was in a later tax year to be allowed a deduction thereof per Section 1341(a)(2), the deduction allowable would also be subject to the same treatment and be reduced by the depletion allowance previously effected for tax purposes. O'Meara v. Commissioner, 8 T.C. 622.

14. It is therefore proper that the deduction to be allowed herein for tax year 1958 under Section 1341(a)(2)

would be in the amount of $366,513.99, and not the entire $505,536.54. The taxpayer received the $505,536.54, in money and restored or repaid that identical sum. However, the taxpayer only paid tax on 72½% thereof or on the amount of $366,513.99, and such amount in the intent of Congress and in the spirit of the legislation should be the deduction allowable in 1958 under Section 1341. Any other procedure would do violence to the spirit of the legislation and the intent of the Congress to afford equitable relief to a taxpayer who thought he had a right to keep certain of his income and paid taxes thereon but it later turns out that he had no such right and was required to restore or repay the same. Congress intended that a taxpayer should get at least equal tax benefit but cannot have intended that a taxpayer should get a deduction allowable for income on which he had not previously paid a tax because of some benefit accruing to the specific income such as a depletion allowance. National and O'Meara, supra.

15. By this procedure the taxpayer herein will get tax benefits in 1958 equal to taxes paid during the preceding years regarding this restored income. This is deemed to be the prime intent of Congress as expressed in the enactment involved herein. H. Rep. No. 1337, 83d Cong., 2d Sess., p. 86 (3 U.S.C. Cong. & Adm. News (1954) 4017, 4113); S. Rep. No. 1622, 83d Cong., 2d Sess., 118 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4751).

16. As the defendant is in no way reopening or readjusting plaintiff's returns for the years 1952-1957, there is no violation of the annual accounting concept. Arrowsmith v. Commissioner, 344 U.S. 6, 97 L.Ed. 6, 73 S.Ct. 71 (1952); Douglas v. Commissioner, 322 U.S. 275, 88 L.Ed. 1271, 64 S.Ct. 988 (1944).

DECISION.

It is the decision, therefore, of the Court for the foregoing reasons that the plaintiff should receive nothing herein except that per stipulation herein the plaintiff should recover judgment herein in the sum of $20,932.64 plus statutory interest thereon against the defendant herein.

The defendant will prepare an appropriate judgment based on the foregoing for signature of the Court. Rule 58, F.R.Civ.P. 28 U.S.C.A.

Dated this 2 day of June, 1966.

FRED DAUGHERTY
United States District Judge.

Filed June 2, 1966.

JUDGMENT

This cause came before this Court for consideration and decision on a Joint Stipulation of Facts and Briefs filed by the parties herein, and, upon consideration of the same, this Court entered its Findings of Fact, Conclusions of Law and Decision herein on June 2, 1966. In accordance with the Findings of Fact, Conclusions of Law and Decision of this Court, it is hereby

Ordered, Adjudged and Decreed that, in accordance with the parties' Joint Stipulation of Facts, the plaintiff have and recover of and from the defendant the amount of $20,932.64, together with interest thereon according to law; it is further

Ordered, Adjudged and Decreed that the complaint and action herein be dismissed with prejudice insofar as any recovery greater than that above-cited is claimed.

Entered this 21 day of June, 1966, at Tulsa, Oklahoma.

FRED DAUGHERTY,
United States District Judge.

Filed June 21, 1966.

Approved: Robert J. Casey, Counsel for Plaintiff; John O. Jones, Tax Division, Department of Justice, Counsel for Defendant.

NOTICE OF APPEAL

Notice is hereby given that Skelly Oil Company, Plaintiff above named [and Appellant herein], appeals to the Court of Appeals for the Tenth Circuit from so much of the Judgment entered in this action on the 21 day of June, 1966, as denied Plaintiff's claim for recovery from Defendant of any amount greater than $20,932.64 together with interest thereon according to law.

Dated: 22 day of June, 1966.

ROBERT J. CASEY

Of Counsel:

Clark, Carr & Ellis

DONALD P. MOYERS

Of Counsel:

Martin, Logan, Moyers,
Martin Conway.

Filed June 22, 1966.

No. 8822 DOCKET ENTRIES IN COURT OF APPEALS

Date	
7-15-66	Statement of points relied on by taxpayer.
4-20-67	Opinion, Seth, J.
4-20-67	Judgment.
6-26-67	Order granting rehearing.
4- 3-68	Opinion on rehearing, Seth, J.
4- 3-68	Dissenting opinion on rehearing, Hill, J.
4- 3-68	Judgment.

IN THE UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

No. 8822

SKELLY OIL COMPANY, APPELLANT

vs.

UNITED STATES OF AMERICA, APPELLEE

APPELLANT'S STATEMENT OF POINTS RELIED ON

The points upon which appellant intends to rely on this appeal are as follows:

1. The District Court erred in applying Title 26, United States Code, Section 1341(a)(4) in that it concluded that Plaintiff-Appellant is not entitled to the full amount of the otherwise allowable deduction of $505,536.54 for the taxable year 1958, because the stipulated facts clearly indicate that Plaintiff-Appellant meets each of the requirements necessary to a deduction in such amount, said requirements being set forth in Title 26, United States Code, Sections 1341(a)(1), (a)(2) and (a)(3).

2. The District Court's Finding of Fact set forth in paragraph 6 of its Finding of Fact is erroneous, because said Finding is not supported by the Record, and further because Title 26, United States Code, Section 1341 is clear and unambiguous when applied to the issue in this proceeding.

3. The District Court erred as a matter of law in resorting to the legislative history which accompanied the enactment of Title 26, United States Code, Section 1341, because as enacted, said Section 1341 is clear and unambiguous.

4. Assuming resort to the aforesaid legislative history is permissible, the District Court erred in concluding that Congress, in enacting Title 26, United States Code, Sec-

tion 1341(a)(4), intended to limit an otherwise allowable deduction in the current year to an amount measured by the amount previously included in taxable income with respect to the restored item in the year or years of its original receipt because:

a. the legislative history does not express any such intention;

b. such a conclusion results in the application to Plaintiff-Appellant of the "transactional approach" to restored claim of right income which has been expressly rejected by the Courts and the Congress;

c. such a conclusion violates the annual accounting concept which was expressly adopted by Congress in its enactment of Title 26, United States Code, Section 1341; and

d. such conclusion is inconsistent with Title 26, United States Code, Section 1341 itself, which provides that the tax shall be the lesser of the tax computed pursuant to subsection (a)(4) and the tax computed pursuant to subsection (a)(5) thereof.

5. The District Court erred in relying on the Tax Court's decision in Maurice P. O'Meara, 8 T.C. 622 (1947) because said case:

a. was decided prior to the enactment of Title 26, United States Code, Section 1341(a)(4);

b. is not controlling under Title 26, United States Code, Section 1341(a)(4);

c. is factually distinguishable from this proceeding; and

d. reflects inconsistent holdings by the Tax Court.

6. The District Court erred by failing to conclude that Defendant-Appellee's adjustment of Plaintiff-Appellant's percentage depletion deduction by the amount of $139,022.55 for the year 1958 was erroneous without regard to the merits of the issue of whether Title 26, United States Code, Section 1341(a)(4) would reduce an otherwise allowable deduction.

7. The District Court erred in failing to conclude that Defendant-Appellee has abandoned any contention that said percentage depletion allowance should be so reduced, because Defendant-Appellee failed to present to said District Court any argument directed to that proposition.

8. In concluding that Congress intended to restrict an otherwise allowable deduction to reflect the tax detriment suffered on account of the inclusion of the restored item in taxable income for the prior year or years, the District Court erred in presuming that Congress would legislate a nullity in subsection (a)(4) of Title 26, United States Code, Section 1341.

Dated: July 14, 1966.

ROBERT J. CASEY

Of Counsel:
Clark, Carr & Ellis

DONALD P. MOYERS

Of Counsel:
Martin, Logan, Moyers, Martin & Conway.

Filed July 15, 1966.

OPINION

Filed, United States Court of Appeals, Tenth Circuit, Apr 20, 1967, William L. Whittaker, Clerk

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UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

No. 8822—APRIL 1967 TERM

SKELLY OIL COMPANY, APPELLANT

v.

UNITED STATES OF AMERICA, APPELLEE

Appeal From The United States District Court For The Northern District of Oklahoma.

Robert J. Casey, New York City (Donald P. Moyers, Tulsa, Okla.; Of Counsel, Clark, Carr & Ellis, New York City, and Martin, Logan, Moyers, Martin & Conway, Tulsa, Okla., with him on the Brief), for Appellant.

Myron C. Baum, Attorney, Department of Justice, Washington, D.C. (Mitchell Rogovin, Assistant Attorney General, Lee A. Jackson, Melva M. Graney, Loring W. Post, Attorneys, Department of Justice, Washington, D. C.; Of Counsel, John M. Imel, United States Attorney, and Lawrence A. McSoud, Assistant United States Attorney, Tulsa, Okla., with him on the Brief), for Appellee.

Before MURRAH, Chief Judge, HILL and SETH, Circuit Judges.

SETH, Circuit Judge.

The appellant brought this action for refund of income taxes on the ground that it was entitled in full to a deduction under Section 1341(a) (4) of the Internal Revenue Code of 1954, for refunds to corporations which purchased gas from it made following a price reduction.

The trial court reduced the claimed deduction by the amount of the percentage depletion deduction, and the taxpayer has taken this appeal.

The appellant has been in the business of producing and selling natural gas in Oklahoma for many years, and was so engaged during the period when a state minimum price order for natural gas sales at the wellhead was put into effect. This order raised the price of the gas appellant was selling under preexisting contracts, and continued in effect until it was declared invalid in Michigan Wisconsin Pipe Line Co. v. Corporation Commission of Oklahoma, 355 U.S. 425. After the order was terminated, a purchaser of gas from appellant during the period the order was in effect brought a suit to recover from Skelly the difference between the contract rate and the price order rate. This suit was settled by the repayment by appellant to the purchaser of the sum of $500,000.00. Appellant paid another purchaser in a similar position the sum of $5,536.54.

The total of these two amounts was claimed and entered in its return as a deduction in 1958, the year it was paid. This was done pursuant to Section 1341(a) (4) of the Code of 1954 in that it was established after the close of the prior taxable years that the taxpayer did not have an "unrestricted right" to such "an item" which was included in its gross income because it appeared it had such right for several prior taxable years, 1952 through 1957.

As indictated above, appellant claimed it was entitled to deduct the entire amount of the refunds. The trial

court did not allow this amount, but instead reduced it by 27-½ per cent which was the percentage appellant had deducted in its returns for the years 1952-57 from its gas sales as depletion.

The statute (Section 1341 of the Internal Revenue Code of 1954) provides in part that:

> "(a) General rule—If—
>
> "(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;
>
> "(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and
>
> "(3) the amount of such deduction exceeds $3,000,
>
> "then the tax imposed by this chapter for the taxable year shall be the lesser of the following:
>
> "(4) the tax for the taxable year computed with such deduction; or
>
> "(5) an amount equal to—
>
> "(A) the tax for the taxable year computed without such deduction, minus
>
> "(B) the decrease in tax . . . for the prior taxable year . . . which would result solely from the exclusion of such item . . . from gross income for such prior taxable year . . . ."

The parties stipulated in the trial court that appellant's taxes for the year 1958 are to be computed under the above subsection (a) (4).

As to the ground rules, it is apparent that the burden was on the appellant under these circumstances to establish a deduction. Corn Products Refining Co. v. Comm'r,

350 U.S. 46. Further as a general proposition a narrow construction is placed on statutory provisions for deductions. United States v. Olympic Radio & Television, Inc., 349 U.S. 232. The rules as to construction generally are contained in United States v. Allen, 293 F.2d 916 (10th Cir.), and in United States v. American Trucking Ass'ns, Inc., 310 U.S. 534.

The taxpayer argues on this appeal that the express wording of the section should be applied, and there are involved at least two separate and distinct tax events each fitting nicely into the statutory language. It also urges that the deduction dollars were without question paid out, and cannot be or should not be traced to their origin in a prior year.

On the other hand the Government argues that Congress could not have intended that such a benefit accrue to the taxpayer, that the several events are related, and one should be used to define the other.

The trial court concluded that the section was not clear, and resort should be had to its legislative history. Also it concluded that the policy of the legislation would not permit the result sought by the taxpayer, it being an unreasonable one. The court concluded that: "Congress intended that a taxpayer should get at least equal tax benefit but cannot have intended that a taxpayer should get a deduction allowable for income on which he had not previously paid a tax because of some benefit accruing to the specific income such as a depletion allowance. National and O'Meara, supra."

When the facts in the case at bar are set against the bare wording of the statute it appears that the requirements are satisfied to permit a deduction in the full amount. The "item" here considered was included in the "gross income" of the taxpayer during the several years prior to 1958, and it appeared that it had the unrestricted right thereto. Further "a deduction is allowable for the taxable year [1958]" because the facts show that after 1957 the taxpayer did not have the unrestricted right to "a portion of such item," and the amount of the deduction is greater than $3,000.00. Thus the tax for 1958 would be computed with "such deduction." It is apparent that

the term "gross income," "exclusion," and "deduction" used in the statute have well defined meanings. The parties stipulated that the $505,536.54 had all been included in the taxpayer's "gross income" for the years 1952-57. Thus if the wording is applied without more, the appellant is entitled to the entire deduction.

Before Section 1341 was enacted, a taxpayer in appellant's position was permitted to deduct the amount of the item restored in the year it was so returned. The "claim of right" doctrine was firmly established by North American Oil Consol. v. Burnet, 286 U.S. 417. There was no alternative, however, if any remedy was sought as was held in both United States v. Lewis, 340 U.S. 590, and in Healy v. Comm'r, 345 U.S. 278. There thus existed the possibility that the taxpayer would be benefitted by the deduction over the treatment he would otherwise have received, or that he would be prejudiced. The result was then determined by a number of factors in the tax computation for the two or more years including the most obvious one—a change in tax rates. Thus the taxpayer in the pre-Section 1341 period was at the mercy of the circumstances with no choice given to him. The above cited cases establishing and refining the "claim of right" rule also reiterated the annual accounting doctrine and asserted it must be applied despite inequities which might arise from it.

For the present consideration it is sufficient to note that before Section 1341 a taxpayer by virtue of the permitted deduction could receive more benefit than the tax originally paid by him upon the "item" which had to be restored. Thus a benefit in the current year was recognized as a possibility, but not limited or related to the tax paid on the item in the previous year. It was then treated as any other deduction for these purposes in the year of restoration.

The change in "law" by the statutory enactment of Section 1341, considering the wording alone, was by the addition of the provision in subsection (a) (5) directed to those taxpayers who would suffer a disadvantage by the use of a current year deduction. This prejudice was removed by permitting the recomputation of taxes for the

current year without the deduction and then a reduction of the tax so computed by the amount of tax attributable to the use of the restored amount in the earlier year if such a route would result in a lesser tax than would a current year deduction. The alternative recomputation provision appears in subsection (a) (5), and the current year deduction is recognized in (a) (4), as it existed before in a non-statutory form. It must be assumed that Congress had a real purpose in enacting the new remedy in (a) (5), and that it was to afford some needed relief in giving the taxpayer an alternative. There is nothing in the enactment itself to indicate an attempt to change the current year deduction remedy.

Thus it appears that Congress by Section 1341 enacted the existing rule as to current year deductions, and added another and new provision whereby the taxpayer who qualifies can always receive a tax benefit from the deduction at least equal to the tax on the item when added to income, "and may receive a tax benefit of a greater amount." 2 Mertens, Law of Federal Income Taxation 340, ch. 12, § 12.106a (Zimet & Stanley Rev.). Thus it must be concluded that Congress sought to make no change in the current year deduction remedy, but only added the recomputation provision. The statutory enactment may have been precipitated by the strict application of the annual accounting rule in cases such as Healy v. Comm'r, 345 U.S. 278, 14 Oil & Gas Tax Quarterly 70.

The trial court found that the section was unclear or ambiguous, and resorted to the legislative history of the enactment of Section 1341. We do not decide whether or not the resort to the history was proper, or whether the wording is without such ambiguity. The legislative history leads to the same conclusion as does the examination of the preexisting state of the law and the statutory language described above.

The cases permit the examination of transactions taking place in prior years to identify or to characterize transactions in the current year. Arrowsmith v. Comm'r, 344 U.S. 6 (a pre-Section 1341 case), is an example. This may be done without violating the annual accounting principle, and a form of it appears in subsection (a) (5);

however, we see no reason in the Act to reexamine the prior years' transactions in the case before us. The statute in subsection (a) (4), with which we are here concerned, does not require or indicate in any way that this be done.

The Government places great reliance on O'Meara v. Comm'r, 8 T.C. 622, 1947. There the taxpayer reported as income certain royalties received from oil production. He was later found by a court not to have title to the lease or land and had to repay the amounts received. This factor is an obvious distinction from the case at bar. There the question became whether the taxpayer was entitled to any deduction at all in the current year. See also Parr v. Scofield, 185 F.2d 535 (5th Cir.). The Tax Court in O'Meara held the taxpayer was entitled to a deduction in the current year of the amount repaid less the depletion allowance. The point with which we are here concerned is not developed in the opinion as the court does not indicate how the deduction for depletion should be applied. In any event the subsequent enactment of Section 1341 without stating any conditions or adjustments makes the cited case of doubtful authority.

To apply the rule sought by the Government would require the imposition of a limitation on the use of Section 1341(a) (4) determined by the amount of taxes paid by appellant in the prior years. There was no limitation or adjustment required in the doctrine expressed in (a) (4) before its enactment, and none is indicated in the statute. There appears to be no relationship established by Congress between (a) (4) and the prior year's computation other than those expressed in the Act, none of which are here pertinent. The Section only requires the tax for the current year to be figured "with such deduction."

There is no authority to permit a readjustment of the depletion allowance of the prior years nor may later happenings alter it. Hugoton Production Co. v. United States, 349 F.2d 418 (Ct.Cl.).

Further there is no indication that the source of the dollars used in the repayment was to be considered before Section 1341 (a) (4) nor thereafter, any more than the source of the dollars used for other deductions.

Much could be written on the subject of general policy about the result of this application of the statute without a judicial addition of conditions. This is however a specific, narrow statutory provision for a particular set of circumstances, and no broad general policy of Congress is indicated. The words used in the section have a clearly recognized meaning in the tax field, and the whole section is consistent when applied as its words direct. The refund problem and depletion was well recognized at the time of the statutory enactment.

The benefit which may accrue to the appellant is large, and thus it is different from previous instances where the benefit was small although well recognized; however, we see no reason to make a distinction based on the amount of money involved to override the statutory provisions. The trial court made no such distinction, but instead indicated that the general principles and the O'Meara case led to an addition of requirements not expressed in the statute. We cannot agree with this either, as the mandate of Congress is clear.

REVERSED.

JUDGMENT

TWENTY-FIFTH DAY, MARCH TERM, THURSDAY, APRIL 20th, 1967.

Before Honorable Alfred P. Murrah, Chief Judge, and Honorable Delmas C. Hill and Honorable Oliver Seth, Circuit Judges.

SKELLY OIL COMPANY, APPELLANT

vs.

UNITED STATES OF AMERICA, APPELLEE

Appeal from the United States District Court for the Northern District of Oklahoma.

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Oklahoma and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the judgment of the said district court in this cause be and the same is hereby reversed, and that this cause be and the same is hereby remanded to the said district court for further proceedings in accordance with the views expressed in the opinion of the court.

ORDER GRANTING REHEARING

Before Honorable Alfred P. Murrah, Chief Judge, and Honorable Delmas C. Hill and Honorable Oliver Seth, Circuit Judges.

SKELLY OIL COMPANY, APPELLANT

vs.

UNITED STATES OF AMERICA, APPELLEE

Appeal from the United States District Court for the Northern District of Oklahoma.

It is ordered that the petition for rehearing is granted and that this cause be set for re-argument July 13, 1967.

It is further ordered that the judgment of this court entered April 20, 1967, is vacated.

OPINION

Filed, United States Court of Appeals, Tenth Circuit, April 3, 1968, William L. Whittaker, Clerk

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UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

No. 8822—MARCH 1968 TERM

SKELLY OIL COMPANY, APPELLANT

v.

UNITED STATES OF AMERICA, APPELLEE

ON PETITION FOR REHEARING

Robert J. Casey, New York City (Thomas E. Tyre, John A. Craig, and Clark, Carr & Ellis, New York City, of Counsel, with him on Brief in Regard to Appellee's Petition for Rehearing), for Appellant.

Myron C. Baum, Attorney, Department of Justice, Washington, D.C. (Mitchell Rogovin, Assistant Attorney General, Lee A. Jackson, Loring W. Post, Attorneys, Department of Justice, Washington, D.C., with him on Petition for Rehearing), for Appellee.

Before MURRAH, Chief Judge, HILL and SETH, Circuit Judges.

SETH, Circuit Judge.

The appellee filed a petition for rehearing which was granted. Additional briefs were submitted and oral argument was heard.

The parties, for better or worse, agreed during the litigation that 26 U.S.C. § 1341(a)(4) was the applicable provision. The case was tried on this basis and so presented to this court.

On rehearing, as well as on the original presentation, the Government urges that the case of O'Meara v. Comm'r, 8 T.C. 622 (1947), is determinative of the issue. The Government also urges that a construction of the section contrary to their position is not in accordance with the "spirit" of the legislation.

We are not prepared to rest this decision on the "spirit" of this portion of the statute. The rules of statutory construction are well established, and we are faced with a clearly worded section which refers to a very narrow point. This is not a provision referring to a matter of broad scope. Under these circumstances we must take it at face value.

The continued reliance by the Government on O'Meara v. Comm'r, 8 T.C. 622 (1947), is of little assistance, but it is understandable. It is obviously part of the pre-statute (1954) case law on this point, but if it did develop any new condition, such a condition was not carried over into the present section of the law. The matter of refunds of this character was well known when the statute was enacted, and we must assume that if Congress intended to create a condition as to the applicability of the section, it would have done so.

The O'Meara case does not purport to define "deductions" or anything else. This term, and the others here concerned, were defined by a myriad of cases where the issue was involved, both before and after O'Meara. Thus O'Meara was obviously part of the case law, but nothing it decided was incorporated in the statute nor influenced the construction of established tax terminology.

As stated in the original opinion, under these circumstances we cannot add a condition to the statute expressly or by a redefinition of terms, although we might wish to do so in view of the results. It is apparent that some remedial steps should be taken, but we cannot do so.

We adhere to our original opinion and disposition of the case. REVERSED.

HILL, Circuit Judge, Dissenting.

This is a close and difficult case and one that has caused each member of the panel to burn some midnight oil. After the case was first submitted to us I agreed with my brothers that by a strict interpretation of 26 U.S.C. § 1341(a)(4) appellant was entitled to prevail and the opinion of the court was so written. Thereafter, and by a unanimous vote, a petition for rehearing was granted and the case was reargued, I then became convinced that our original decision was not correct and that the trial court should be affirmed. Therefore, I must now respectfully dissent.

I believe the trial judge was correct in reasoning that § 1341(a)(4) did not create a new deduction and that thus the O'Meara decision [1] applied in the determination of the deduction allowable. The majority fails to present any reason for divorcing the determination of the deduction from its initiating basis.

The cornerstone of appellant's argument and the position apparently accepted by the majority is that "the statute utilizes interchangeably the phrase 'item included in gross income in prior year' with the term 'deduction.'" It is my contention that these two phrases are not used interchangeably and that a more reasonable interpretation of the statute is that the "deduction" to be allowed may in appropriate situations differ significantly from the item included in gross income. At no time does the majority define "deduction" as it is used in § 1341. It is, however, asserted that "deduction" has a well defined meaning. This can only refer to the meaning developed in pre-1341 cases dealing with the problem of refund of prior "claim of right" income. Indeed the majority recognizes that "the current year deduction is recognized in (a)(4) as it existed before in a non-statutory form." However, the majority's further statement that prior to the enactment of § 1341 "a taxpayer in appellant's position was permitted to deduct the amount of the item restored in the year it was so returned" without any reference to the O'Meara decision is misleading to say the least and is undoubtedly the crucial error in the majority's reasoning. O'Meara is

[1] Maurice P. O'Meara, 8 T.C. 622 (1947).

bypassed by my distinguished brothers with the statement that "The point with which we are here concerned is not developed in the opinion as the court does not indicate how the deduction for depletion should be applied. In any event the subsequent enactment of Section 1341 without stating any conditions or adjustments makes the cited case of doubtful authority."

To me it is much more reasonable to say that the existence of O'Meara in the case law pre-dating the enactment of § 1341 means that it must be considered as a part of the definition of "deduction" that arises from the case law. Certainly an examination of O'Meara shows that the court considered the problem of the effect of taking a prior depletion deduction on claim of right income which was later returned. The O'Meara case concerned a suit for refund of taxes which had been previously paid by O'Meara on royalties received from certain oil properties which had been acquired by O'Meara by warranty deed. During the years when such income was included O'Meara had taken the allowable depletion allowance on such royalties. Subsequently as a result of litigation O'Meara was held to have had unlawful possession of the mineral properties and was required to pay over all royalties received from such property. On his later return O'Meara deducted the amount so repaid and this deduction was disallowed by the Commissioner. The Tax Court reversed the Commissioner's rule and allowed the deduction,[2] limiting it and reducing it by the amount that O'Meara had previously taken as a depletion allowance.

Concerning the problem of reduction of the allowable deduction the court in O'Meara stated:

> "[T]he amount of loss for which petitioner is entitled to the deduction must be limited by the amount of the royalty income reported for tax purposes after

[2] It is interesting to note that in 1341(a)(1) the term "an item included in gross income" is used as a requirement for the application of the statute. This same requirement was established in O'Meara, supra, to be the sole requirement for the establishment of a basis for later gains or losses. As discussed later there is, however, a significant difference between establishing a basis and allowing the full amount as a deduction.

deducting for depletion. It makes little difference whether the depletion deduction be viewed as a diminution of income, thereby resulting in effect in a reporting by petitioner of only the net amount of 72½% of the royalties received rather than 100%, or whether we recognize that the depletion deduction is permitted to one in the position of the owner of the oil in place or of a depletable interest therein, and that when it developed that petitioner was not the owner the deduction became erroneous, and petitioner is required to include the deducted amount as income in the year when that situation appears; see Douglas v. Commissioner, 322 U.S. 275; or whether the adjustment is viewed as required by the statutory definition of basis. Section 113(b)(1)(B), I.R.C. See Virginia Hotel Corp. v. Helvering, 319 U.S. 523. In any event, the net amount of the loss for which petitioner is entitled to take a deduction is the total of the royalties reported less the amount deducted for depletion." O'Meara, supra, at 634-5.

Appellant asserts that only the second of the above mentioned grounds for the reduction is valid; since in the instant case there was no question but that Skelly was at all times the legal owner of the land the O'Meara case is distinguishable and not applicable to the instant case. Apparently the court in O'Meara, however, felt that any of the above three mentioned grounds would be sufficient to uphold the government's argument that the deduction should be reduced by the amount of the depletion deduction previously taken.

I suggest that O'Meara stands for the basic principle that a basis established for gain or loss by the inclusion of income under a claim of right, which income has been the basis for a percentage depletion deduction, must be limited by that amount of the directly related deduction,[3] and

[3] A short analysis of the depletion deduction shows its direct relation to the gross income produced from a well and illustrates further why in recognizing a deduction for return of such income cognizance must be given the percentage depletion deduction.

A depletion deduction is allowed a taxpayer whose income results from production from a natural resource. In receiving such income

that the reasoning and applicability of the O'Meara decision is just as applicable today as it was before the enactment of § 1341. I agree entirely with Judge Daugherty when he states "Any other procedure would do violence to the spirit of the legislation and the intent of the Congress to afford equitable relief to a taxpayer who thought he had a right to keep certain of his income and paid taxes thereon but it later turns out that he had no such right and was required to restore or repay the same. Congress intended that a taxpayer should get at least equal tax benefit but cannot have intended that a taxpayer should get a deduction allowable for income on which he had not previously paid a tax because of some benefit accruing to the specific income such as a depletion allowance." In fact any other position would appear to be totally unreasonable. The resulting effect would be that two measures intended to relieve and benefit the taxpayers can combine to result in a windfall to the taxpayer greatly exceeding the benefit which might result from the separate application of these measures. That such an overall result was intended seems unlikely.

It was argued by appellant that the statement of the court in O'Meara that "the process of establishing a basis

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the natural resource is depleted, thus depleting the taxpayer's capital investment. In computing other forms of income, i.e., such as a manufacturer's income, the capital investment of the manufacturer is considered and deducted. Thus in a similar sense a depletion deduction from income received from a natural resource is allowed as a return of the taxpayer's capital. 4 Mertens, § 24.02. Such depletion allowance was originally considered on two grounds, a cost depletion and a discovery depletion. Both of these depletion allowances had a specific limit upon the total amount of depletion that could be taken; however, these depletion limitations proved somewhat unsatisfactory as they made computation of the depletion difficult. Therefore, a percentage depletion deduction was established whereby the depletion deduction was made a direct function of the amount of income received from the natural resource. 4 Mertens, § 24.04. There is no limitation on the amount of depletion deductions which may be taken over a period of years such as with the cost of depletion or like the depreciation allowance allowed for the equipment used by a manufacturer. It is clear in fact that the total depletion deduction taken from a natural resource could far exceed the total cost of the natural resource. Commissioner v. Southwest Exploration Co., 350 U.S. 308.

for an income item consists * * * of reporting it in the taxpayer's gross income * * *" Id. at 633, required that no further consideration be given to any depletion deduction taken from said income in the computation of the deduction allowable in the year of the repayment. The Tax Court in making this statement, however, was not considering the problem of the amount of deduction allowable but merely that the government did not have to receive any tax benefit from the inclusion of the income in the return in the prior year. The mere reporting of the item as gross income established a basis. The court, however, did not go on to say that the entire item included in gross income would establish the amount of the basis. This was not considered until the later portion of the opinion quoted above, where the court found that the deduction allowable was not equatable with the total amount included in gross income but was limited by the depletion deduction previously taken. No inconsistency results from saying that the inclusion of an item in gross income establishes a basis for later deductions notwithstanding lack of tax benefit to the government but not allowing a taxpayer to include the entire amount included in gross income as a basis for deduction.

Consideration of the percentage depletion deduction in determining the deduction allowable under § 1341 does not violate the annual accounting concept as established by Burnett v. Sanford & Brooks Co., 282 U.S. 359, as the consideration of the prior years' returns is only for the purpose of determining the amount of the allowable deduction in the present year's return. There is no reopening or refiguring of prior years' taxes, merely a computation of the present year's taxes. That consideration of the prior years' returns may be made is clearly established by cases such as Arrowsmith v. Commissioner, 344 U.S. 6; Douglas v. Commissioner, 322 U.S. 275; and Dobson v. Commissioner, 320 U.S. 489. Cases cited by appellant such as Healy v. Commissioner, 345 U.S. 278, concern the taxpayer's proposition that the tax for the prior years be recomputed and that refunds be made from the taxes paid in the prior years. This situation is clearly not the one before us in the instant case. Here, as mentioned above, we are merely determining the

amount of the allowable "deduction" in the present taxpaying year. The majority cites the case of Hugoton Production Co. v. United States, 349 F.2d 418, as authority for the proposition that consideration may not be given of the prior taxpayer years. The Hugoton case, however, is not direct authority for this proposition. That case involved the determination of the price received by similarly situated producers for purposes of establishing wellhead prices for depletion allowances. In the computation of such prices, the court stated that it could not consider refunds made by such other producers under situations similar to that of the instant case and gave as its reasons for not considering such refunds the annual accounting concept. The court went on to note, however, that such refunds would be reflected in any respect as they were considered in the subsequent years when the repayments were made. It should suffice for the Hugoton case to say that the question considered by the court there was not the question which we are considering in the instant case. One could go on to question, however, whether the application of the annual accounting concept to the situation found in the Hugoton case required the result reached by that court. In any respect it is reasonable to say that consideration of prior depletion deductions allowed in computing a "deduction" allowable under §1341(a)(4) for a current tax year is not a violation of the annual accounting concept.

In summary, the deduction for refunded claim of right income as originally established by case-law and continued by § 1341 was to provide relief for a taxpayer from the application of the strict claim of right doctrine. It is unreasonable to transfer such relief into a windfall for the taxpayer unless such a result is clearly and unavoidably required. A double deduction should not be given unless there is virtually no alternative. Here I believe the more reasonable decision to be to limit appellant's allowable deduction by the amount of percentage depletion deduction previously claimed.

JUDGMENT

MARCH TERM, WEDNESDAY, APRIL 3rd, 1968.

Before Honorable Alfred P. Murrah, Chief Judge, and Honorable Delmas C. Hill and Honorable Oliver Seth, Circuit Judges

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SKELLY OIL COMPANY, APPELLANT

vs.

UNITED STATES OF AMERICA, APPELLEE

Appeal from the United States District Court for the Northern District of Oklahoma.

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Oklahoma and was argued by counsel on January 10, 1967. On April 20, 1967, an opinion was filed reversing the judgment of the district court and remanding the cause to the said district court for further proceedings in accordance with the views expressed in the opinion of the court, and on that same date judgment in accordance with the opinion was entered. Thereafter on June 26, 1967, appellee's petition for rehearing was granted, the judgment of April 20, 1967, was vacated, and the cause was reargued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the judgment entered on April 20, 1967, be and the same is hereby reinstated and the judgment of the said district court is reversed and the cause remanded to the district court for further proceedings in accordance with the views expressed in the opinion of the court.

Honorable Delmas C. Hill, Circuit Judge, dissented.

SUPREME COURT OF THE UNITED STATES

No. 280, October Term, 1968

UNITED STATES, PETITIONER

v.

SKELLY OIL COMPANY

ORDER ALLOWING CERTIORARI—Filed October 14, 1968.

The petition herein for a writ of certiorari to the United States Court of Appeals for the Tenth Circuit is granted, and the case is placed on the summary calendar.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

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In the Supreme Court of the United States

OCTOBER TERM, 1968

No. ——

UNITED STATES OF AMERICA, PETITIONER

v.

SKELLY OIL COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Tenth Circuit in this case.

OPINIONS BELOW

The findings of fact, conclusions of law and decision of the district court (R. 20-30)[1] are reported at 255 F.Supp. 228. The initial opinion of the court of appeals (App. A 1-10) and the majority (App. D 13-15) and dissenting (App. D 15-23) opinions on rehearing are reported in 392 F.2d 128.

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[1] "R." references are to the printed record in the court of appeals. "App." refers to the appendix to this petition.

JURISDICTION

The initial judgment of the court of appeals was entered on April 20, 1967 (App. B 11). The government's petition for rehearing was granted on June 27, 1967 (App. C 12). The judgment on rehearing was entered on April 3, 1968 (App. E 24-25). On July 2, 1968, Mr. Justice Brennan entered an order extending the time for filing a petition to and including July 9, 1968. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether respondent, a producer of natural gas, in computing its taxable income for 1958, was entitled, as the court below held, to deduct the full amount of overcharges ($505,536) it refunded to customers in that year, or whether the deduction should be reduced, as the government contends, by 27½ percent or $139,022, representing depletion claimed and allowed as a deduction in computing taxable income in the prior years when respondent had included the $505,536 in its gross income.

STATUTE AND REGULATION INVOLVED

Internal Revenue Code of 1954:

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) *General Rule*—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in com-

puting taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. For purposes of this part, the term "mines" includes deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under section 613 (c). In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.

* * * *

(26 U.S.C. 611.)

SEC. 613. PERCENTAGE DEPLETION.

(a) *General Rule.*—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

(b) *Percentage Depletion Rates.*—The mines, wells, and other natural deposits, and the per-

centages, referred to in subsection (a) are as follows:

(1) 27½ percent—oil and gas wells.

* * * *

(26 U.S.C. 613.)

SEC. 1341. COMPUTATION OF TAX WHERE TAXPAYER RESTORES SUBSTANTIAL AMOUNT HELD UNDER CLAIM OF RIGHT.

(a) *General Rule.*—If—

(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;

(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

(3) the amount of such deduction exceeds $3,000,

then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

(4) the tax for the taxable year computed with such deduction; or

(5) an amount equal to—

(A) the tax for the taxable year computed without such deduction, minus

(B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of

such item (or portion thereof) from gross income for such prior taxable year (or years).

* * * *

Treasury Regulations on Income Tax (1954 Code):

§ 1.1341-1 *Restoration of amounts received or accrued under claim of right.*—(a) *In general.*—(1) If, during the taxable year, the taxpayer is entitled under other provisions of chapter 1 of the Internal Revenue Code of 1954 to a deduction of more than $3,000 because of the restoration to another of an item which was included in the taxpayer's gross income for a prior taxable year (or years) under a claim of right, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year shall be the tax provided in paragraph (b) of this section.

* * * *

(b) *Determination of tax.* (1) Under the circumstances described in paragraph (a) of this section, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year shall be the lesser of—

(i) The tax for the taxable year computed under section 1341(a)(4), that is, with the deduction taken into account, or

(ii) The tax for the taxable year computed under section 1341(a)(5), that is, without taking such deduction into account, minus the decrease in tax * * * for the prior taxable year (or years) which would result solely from the exclusion from gross income of all or that portion of the income included under a claim of right to which the deduction is attributable. * * *

* * * *

(26 C.F.R. 1.1341-1.)

STATEMENT

Respondent produces natural gas in Oklahoma (R. 14, 21; App. A 2). By order effective August 1, 1952, the Oklahoma Corporation Commission established a mandatory minimum price for sales of natural gas. In 1958, this Court ruled that the Oklahoma Commission was without jurisdiction. *Michigan Wisconsin Pipeline Co.* v. *Corporation Commission of Oklahoma*, 355 U.S. 425. On remand, the Oklahoma Supreme Court vacated the minimum price order. As the result of litigation, respondent, in 1958, refunded $500,000 to Cities Service Company and $5,536 to Dorchester Corporation, representing excess amounts collected from those two customers under the invalid minimum price order. (R. 14-17, 21-24; App. A 2-3).

Respondent had included those amounts in its gross income as received during the taxable years 1952 through 1957, since it then claimed an unrestricted right to them. In determining its taxable income for each of those prior years, respondent had claimed and the Commissioner of Internal Revenue had allowed percentage depletion with respect to such amounts, at the rate of 27½ percent, for a total of $139,022. (R. 23-25; App. A 3).

In its federal income tax return for 1958, respondent claimed a deduction in the amount of $505,536, the entire amount refunded. The Internal Revenue Service reduced the deduction by the $139,022 depletion allowed in the prior years. Respondent paid the resulting deficiency assessment and filed a claim for refund, which was not allowed. The instant suit for a

refund was then brought in the district court. (R. 25; App. A 3).[2]

The district court sustained the government's position (R. 29-30). The court of appeals, however, reversed, holding that Section 1341 of the Internal Revenue Code of 1954 entitled respondent to deduct the full $505,536 (App. A 1-10). After granting a rehearing, two members of the court of appeals panel adhered to the original decision, and one judge dissented (App. D 13-23).

REASONS FOR GRANTING THE WRIT

1. The decision of the court below is contrary to basic principles of tax accounting long established and recognized by decisions of this Court.

These go back to the fundamental concept of the annual accounting period, illustrated in *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359. They were developed further in *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417, 424, where the Court held that a taxpayer who received money "under a claim of right and without restriction as to its disposition * * * has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent." If repayment is required in a later year, the taxpayer may take a deduction under appropriate provisions of

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[2] The deficiency notice and refund proceedings raised other issues with respect to respondent's 1958 tax liability. These questions were resolved by stipulation in the trial court and are not in issue here. See R. 25-26.

the statute. The relevant provision is that for the deduction of a loss, and this does not authorize any greater deduction than the amount of the loss actually sustained. *Healy* v. *Commissioner*, 345 U.S. 278, 284 and n.17; see G.C.M. 16730, XV-1 Cum. Bull. 179 (1936).

In *Arrowsmith* v. *Commissioner*, 344 U.S. 6, this Court established the proposition that when a repayment is made, the tax consequences of the repayment depend upon the facts surrounding the original receipt. In that case, the taxpayer received sums in liquidation of a corporation which were taxable as a capital gain. Several years later the taxpayer had to make repayment of a portion of the sum he had received. Though there was clearly no "sale or exchange" in the later year, which is the usual earmark of a capital gain or loss, the Court held that these repayments were deductible only as a capital loss, since they arose out of and were a consequence of the prior capital transactions.

The repayment in this case was of money previously received from the production of natural gas; it was included in "the gross income from the property" which Section 613(a) makes the basis for the percentage depletion allowed upon the production of natural gas. The result was that in the years 1952 thru 1957 respondent had taken into net income only 72½ percent of the amounts received in those years and refunded in 1958. Under established rules, any 1958 loss deduction must take into account these antecedent facts, as *Arrowsmith* illustrates. Since the repayment arose directly out of the transactions which gave rise

to the percentage depletion deductions, this fact must be taken into account in determining the amount of the deduction for the loss actually sustained on the repayment.

Putting essentially the same proposition another way, the repayment might be analyzed by allowing a deduction for the full amount repaid, but requiring the restoration of the percentage depletion to income in the year of repayment, since, as events worked out, the respondent did not in fact have this amount as income from the production of gas. Though the earlier depletion deduction was correct when made, the eventual repayment established the fact that no percentage depletion deduction was in fact allowable. There was in fact, to this extent, no receipt from the production of gas, and under correct and established principles of tax accounting, the amount of percentage depletion previously deducted should be restored to income.[8]

It makes no difference which analysis is used, either a reduction of the deduction in the year of repayment, so as to limit the loss to the amount actually included in taxable income, or a deduction of the full repayment with an offsetting credit to income of the amount of the percentage depletion previously deducted, but now shown to have been unwarranted. The result is

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[8] It has long been established, for example, that where an accrual has been made, and deducted, for wages, the amount must be restored to income when it is later determined that the wages are unclaimed. *Chicago, R.I. & P. Railway Co.* v. *Commissioner*, 47 F.2d 990 (C.A. 7), certiorari denied, 284 U.S. 618; *Charleston and Western Carolina Railway Co.* v. *Burnet*, 50 F.2d 342 (C.A. D.C.).

the same. In either case the effective loss deduction is measured by the actual loss sustained.

The impropriety of the result reached by the court below can be illustrated by a parallel example. Suppose that a corporation received a dividend on shares of stock which it owned in another domestic corporation. Under section 61(a)(7) of the Internal Revenue Code, the amount of the dividend received would be includible in gross income. Under section 243(a)(1) of the Code, however, the corporation receiving the dividend is allowed a deduction in the amount of 85% of the dividend received. Thereafter, perhaps as a result of a suit by a minority shareholder, the receiving corporation may be required to repay the amount of the dividend to the paying corporation. Can it be supposed that it would be entitled to deduct the full amount repaid, without any adjustment for the 85% deduction for dividends received which it had taken in an earlier year? This would be carried to the ultimate extreme in the situation where there was a 100% deduction on receipt of the dividend, as is possible in some cases. See sections 243(a)(2) and (3) of the Code.

There can be no doubt that the analysis given above is sound, and that it is sustained by numerous decisions of this and other courts. Unless matters were somehow changed by section 1341, there can be no basis for the result reached below.

2. There is nothing in section 1341 of the Code which requires or warrants that it be interpreted as providing a loophole which would allow an aggregate

deduction in excess of that determined under sound accounting principles or under the previous law.

Section 1341 was first enacted in 1954. Under the previous law, it had been established that the adjustment for a repayment—whatever its character and amount—could be made only in the year of repayment. *United States* v. *Lewis*, 340 U.S. 590; *Healy* v. *Commissioner*, 345 U.S. 278. The effect of section 1341, where it applies, is to give the taxpayer another choice. He can (1) take a deduction in the year of repayment, as before, or (2) he can make an adjustment in the tax of that year by reducing it by the amount that his tax for the prior year was increased by the receipt. The first option is in section 1341(a)(4), and the second in section 1341(a)(5).

In the present case the adjustment for the prior year would clearly be in the amount of the tax resulting from the inclusion in income of the amount received *and* the deduction of 27½% of that amount as percentage depletion—that is, the tax on 72½ percent of the amount received which is the amount of tax respondent paid. The respondent is not interested in that. Instead, it relies on the other alternative provided by the statute, which is, in all essence, the same as that which was available before the statute was passed.

This is apparent when the text of section 1341 is examined. By its terms, section 1341 is applicable if three conditions are met. These are:

If—

(1) an item was included in gross income for a prior taxable year (or years) because it ap-

peared that the taxpayer had an unrestricted right to such item;

(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

(3) the amount of such deduction exceeds $3,000.

The second condition refers to "a deduction" which "is allowable." It does not say "a repayment," or "the amount which is repaid." The words are "a deduction." The statute applies "if a deduction is allowable * * * because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item."

This makes it necessary to determine what deduction would be allowable if section 1341 had not been enacted. It is only that deduction to which section 1341 relates; and this is the amount to which section 1341(a)(4) refers when it says that the tax shall be "the tax for the taxable year computed with such deduction". What is "such deduction"? Obviously this is "a deduction" referred to in section 1341(a)(2). This is not the "item" which "was included in gross income for a prior taxable year" under section 1341(a)(1), but is "a deduction" which results from the fact that it is later established "that the taxpayer did not have an unrestricted right to such item." Nothing in section 1341 specifies the amount of the "deduction," or qualifies or enlarges that amount in any way. That "deduction" must be determined under general

tax principles long established, and is not affected in any way by any of the provisions of section 1341.

This conclusion is supported by the pertinent Treasury Regulations. Section 1.1341-1(a)(1) of the Income Tax Regulations provides that: "If, during the taxable year, the taxpayer *is entitled under other provisions of chapter 1* * * * to a deduction * * *", he may claim one of the options provided in section 1341. (Emphasis supplied.) It is also confirmed by the fact that Section 1341 appears not in Subchapter B, where the deductions allowed in computing taxable income are set forth, but rather in Subchapter Q, which contains a variety of provisions best described by the subchapter title: "Readjustment of tax between years and special limitations."

The legislative history plainly indicates that the only purpose in enacting section 1341 was to provide an alternative to the rules of *Lewis* and *Healy*. There is no hint of an intent to sanction a new deduction clearly denied under prior law. The report of the Senate Committee on Finance states (S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 118, 451):

> Under present law if a taxpayer is obliged to repay amounts which he had received in a prior year and included in income because it appeared that he had an unrestricted right to such amounts, he may take a deduction in the year of restitution. In many instances of this nature, the deduction allowable in the later year does not compensate the taxpayer adequately for the tax paid in the earlier year.
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> * * * *

> If the taxpayer included an item in gross income in one taxable year, and in a subsequent taxable year he becomes entitled to a deduction because the item or a portion thereof is no longer subject to his unrestricted use, and the amount of the deduction is in excess of $3,000, the tax for the subsequent year is reduced by either the tax attributable to the deduction or the decrease in the tax for the prior year attributable to the removal of the item, whichever is greater. Under the rule of the *Lewis* case (340 U.S. 590 (1951)), the taxpayer is entitled to a deduction only in the year of repayment.

See also H. Rep. No. 1337, 83d Cong., 2d Sess., pp. 86-87, A294-A295 (3 U.S.C. Cong. & Adm. News (1954) 4017, 4113, 4436-4437).

The error of the court of appeals results from its confusion of the "item" referred to in section 1341(a)(1) with the "deduction" referred to in sections 1341(a)(2) and (4). Though these two terms are related, they are not necessarily the same, and the court below was wrong when it, in effect, held or assumed that the "deduction" was the same as the amount of the "item" repaid. With this error, the court of appeals opens up a wholly unintended and unnecessary loophole in the statute by reading its language "so broadly * * * as to defeat rather than further the purpose of Congress"—which, as this Court has said, cannot be justified. *Corn Products Co.* v. *Commissioner*, 350 U.S. 46, 52; *Burnet* v. *Harmel*, 287 U.S. 103, 108.

3. In practical effect, the respondent has been allowed two tax deductions of the same amount of

money. First, it took the 27½% depletion deduction when the customers' payments were received. Then it deducted the full amount of the repayment in 1958, including the entire amount previously allowed as depletion. It has long been established that such a double deduction of the same amount should not be allowed unless there is some statutory provision which clearly compels such a result. Thus, in *Ilfeld Co.* v. *Hernandez*, 292 U.S. 62, 68, this Court said:

> If allowed, this would be the practical equivalent of double deduction. In the absence of a provision of the Act definitely requiring it, a purpose so opposed to precedent and equality of treatment of taxpayers will not be attributed to lawmakers. Cf. Burnet v. Aluminum Goods Co., 287 U.S. 544, 551. United States v. Ludey, 274 U.S. 295, 301. There is nothing in the Act that purports to authorize double deduction of losses or in the regulations to suggest that the commissioner construed any of its provisions to empower him to prescribe a regulation that would permit consolidated returns to be made on the basis now claimed by petitioner.

In granting the double deduction here involved, the court of appeals has so far departed from the accepted and usual course of judicial proceedings as to warrant this Court's intervention.

4. The decision of the court of appeals also is inconsistent with the rationale of *Douglas* v. *Commissioner*, 322 U.S. 275. In that case the taxpayer was allowed depletion on minimum royalties received in advance of production. The lease under which the royalties were paid was then cancelled without any production. This

Court approved the regulation (now Treas. Reg. § 1.612-3(b)(2)) which required that the depletion deductions previously taken be restored to income in the year in which the lease was cancelled.

The right to depletion rests on extraction of a mineral and the amount of the allowance is a percentage of the (Section 613(a)) "gross income" resulting from the extraction. Just as the depletion is restored to income when, as in *Douglas*, attempts at extraction are abandoned in a year after the income has been received and reported, see, *e.g.*, *Freeman* v. *Commissioner*, 48 T.C. 96, respondent should be required to make an adjustment for depletion taken in prior years since it later developed that part of the gross income—that which formed the basis for the depletion claimed—had to be refunded.

5. As a consequence of the broad sweep of federal, state and local regulation of the sales price of natural gas,[4] producers often collect and report for income tax purposes amounts later refunded to customers. The Federal Power Commission has advised the Commissioner of Internal Revenue, for example, that customer refunds approaching $95,000,000 are likely to result from two Commission rulings recently approved by this Court. (*Permian Basin Area Rate Cases*, Nos. 90, et al., Oct. 1967 Term, decided May 1, 1968, and *Federal Power Commission* v. *Sunray DX Oil Co.*, Nos. 60, et al., Oct. 1967 Term, decided

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[4] *E.g.*, *The Natural Gas Act* §§ 4, 5, 15 U.S.C. 717c, 717d; *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, See, generally, Federal Power Commission, Federal and State Commission Jurisdiction and Regulation—Electric, Gas, and Telephone Utilities (1967).

May 6, 1968. In other cases, the Federal Power Commission ordered nearly $90,000,000 in refunds in the three year period ending June 30, 1966. Potential refunds of comparable magnitude are at issue in cases still pending before the Commission. An additional large number of customer refunds are likely to result —as did the ones in this case—from the actions of state or local authorities.

The court of appeals has held that a natural gas producer which makes such a refund is entitled to claim total tax deductions of $1.275 for every dollar refunded to customers. In terms of tax liability, respondent pays less than it would have if it had never included the receipts in its income; having originally paid some $190,000 in taxes with respect to the overcharges, it has been granted a refund of $263,000 in a later year, even though tax rates and all other relevant principles of law remained the same throughout the period. Any producer in the same situation may achieve a comparable tax windfall.[5]

The inevitable consequence of the Tenth Circuit's ruling is uncertainty as to the tax liabilities of a large number of producers of natural gas. Because the depletion allowance is 27½ percent (26 U.S.C. 613(b)) and the usual tax rate is the corporate one in the vicinity of 50 percent, the amount of revenue at issue is in the tens of millions of dollars.[6] It is, moreover,

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[5] The refund ordered in the *Permian Basin case, supra*, alone may affect several hundred producers, see note 1, p. 1, of the dissenting opinion.

[6] Between $10,000,000 and $15,000,000 of taxes will be in issue simply as the result of the decision in *Permian Basin*,

essential that the proper tax rule be settled in order to avoid uncertainty in the normal course of rate regulation. An allowance for federal tax liability must be included in the cost of service of every producer. Cf. *Federal Power Commission* v. *United Gas Pipe Line Co.*, 386 U.S. 237. And, so long as the question here remains unsettled, that aspect of every natural gas rate-making proceeding must be attended by an equivalent degree of uncertainty.

There is, as yet, no conflict in decisions of the courts of appeals on the precise issue presented. But the one district court which has considered whether Section 1341(a)(2) in itself defines the "deduction" to which it refers, has sustained the rule of Regulation Section 1.1341-1(a)(1), *i.e.*, that the right to the deduction must rest on other code provisions. It has observed that any other interpretation would be "such a substantial departure from prior practice as to require at least some indication of this purpose in the legislative history of the section if not more precise language within the section itself." *National Life & Accident Ins. Co.* v. *United States*, 244 F. Supp. 135, 141 (M.D. Tenn.), affirmed on other issues, 385 F.2d 832 (C.A. 6). In addition, *O'Meara* v. *Commissioner*, 8 T.C. 622, the only pre-1954 Code case to consider the application of the "claim of right" rule to a depletion problem such as this case presents, held (8 T.C. at 634), as we contend here, "the amount of loss * * * must

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supra and *Sunray DX Oil Co., supra.* The Internal Revenue Service estimates the limitations periods have not yet expired for taxpayer's who are in a position to claim at least another $10,000,000 in refunds.

be limited by the net amount of * * * income reported for tax purposes after deducting for depletion."

The paucity of litigation is simply the result of the fact that taxpayers had not previously argued that Section 1341 should be read to allow a double deduction. If the question is now reviewed, and the governing legal principles set aright by this Court, the newly created uncertainty in the law can be readily resolved. Such a review will lay to rest the host of similar tax claims that have now been generated (see pp. 16-17 and n. 6, *supra*) and thereby avoid the stream of litigation that will otherwise result.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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JULY, 1968.

APPENDIX A

Filed, United States Court of Appeals, Tenth Circuit, Apr 20, 1967, William L. Whittaker, Clerk

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UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

No. 8822—APRIL 1967 TERM

SKELLY OIL COMPANY, APPELLANT

v.

UNITED STATES OF AMERICA, APPELLEE

Appeal From The United States District Court For The Northern District of Oklahoma.

Robert J. Casey, New York City (Donald P. Moyers, Tulsa, Okla.; Of Counsel, Clark, Carr & Ellis, New York City, and Martin, Logan, Moyers, Martin & Conway, Tulsa, Okla., with him on the Brief), for Appellant.

Myron C. Baum, Attorney, Department of Justice, Washington, D.C. (Mitchell Rogovin, Assistant At-

torney General, Lee A. Jackson, Melva M. Graney, Loring W. Post, Attorneys, Department of Justice, Washington, D. C.; Of Counsel, John M. Imel, United States Attorney, and Lawrence A. McSoud, Assistant United States Attorney, Tulsa, Okla., with him on the Brief), for Appellee.

Before MURRAH, Chief Judge, HILL and SETH, Circuit Judges.

SETH, Circuit Judge.

The appellant brought this action for refund of income taxes on the ground that it was entitled in full to a deduction under Section 1341(a) (4) of the Internal Revenue Code of 1954, for refunds to corporations which purchased gas from it made following a price reduction.

The trial court reduced the claimed deduction by the amount of the percentage depletion deduction, and the taxpayer has taken this appeal.

The appellant has been in the business of producing and selling natural gas in Oklahoma for many years, and was so engaged during the period when a state minimum price order for natural gas sales at the wellhead was put into effect. This order raised the price of the gas appellant was selling under preexisting contracts, and continued in effect until it was declared invalid in Michigan Wisconsin Pipe Line Co. v. Corporation Commission of Oklahoma, 355 U.S. 425. After the order was terminated, a purchaser of

gas from appellant during the period the order was in effect brought a suit to recover from Skelly the difference between the contract rate and the price order rate. This suit was settled by the repayment by appellant to the purchaser of the sum of $500,000.00. Appellant paid another purchaser in a similar position the sum of $5,536.54.

The total of these two amounts was claimed and entered in its return as a deduction in 1958, the year it was paid. This was done pursuant to Section 1341 (a) (4) of the Code of 1954 in that it was established after the close of the prior taxable years that the taxpayer did not have an "unrestricted right" to such "an item" which was included in its gross income because it appeared it had such right for several prior taxable years, 1952 through 1957.

As indictated above, appellant claimed it was entitled to deduct the entire amount of the refunds. The trial court did not allow this amount, but instead reduced it by 27-½ per cent which was the percentage appellant had deducted in its returns for the years 1952-57 from its gas sales as depletion.

The statute (Section 1341 of the Internal Revenue Code of 1954) provides in part that:

"(a) General rule—If—

"(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;

"(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that

the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

"(3) the amount of such deduction exceeds $3,000,

"then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

"(4) the tax for the taxable year computed with such deduction; or

"(5) an amount equal to—

"(A) the tax for the taxable year computed without such deduction, minus

"(B) the decrease in tax . . . for the prior taxable year . . . which would result solely from the exclusion of such item . . . from gross income for such prior taxable year . . . ."

The parties stipulated in the trial court that appellant's taxes for the year 1958 are to be computed under the above subsection (a) (4).

As to the ground rules, it is apparent that the burden was on the appellant under these circumstances to establish a deduction. Corn Products Refining Co. v. Comm'r, 350 U.S. 46. Further as a general proposition a narrow construction is placed on statutory provisions for deductions. United States v. Olympic Radio & Television, Inc., 349 U.S. 232. The rules as to construction generally are contained in United States v. Allen, 293 F.2d 916 (10th Cir.), and in United States v. American Trucking Ass'ns, Inc., 310 U.S. 534.

The taxpayer argues on this appeal that the express wording of the section should be applied, and there are involved at least two separate and distinct tax events each fitting nicely into the statutory language. It also urges that the deduction dollars were without question paid out, and cannot be or should not be traced to their origin in a prior year.

On the other hand the Government argues that Congress could not have intended that such a benefit accrue to the taxpayer, that the several events are related, and one should be used to define the other.

The trial court concluded that the section was not clear, and resort should be had to its legislative history. Also it concluded that the policy of the legislation would not permit the result sought by the taxpayer, it being an unreasonable one. The court concluded that: "Congress intended that a taxpayer should get at least equal tax benefit but cannot have intended that a taxpayer should get a deduction allowable for income on which he had not previously paid a tax because of some benefit accruing to the specific income such as a depletion allowance. National and O'Meara, supra."

When the facts in the case at bar are set against the bare wording of the statute it appears that the requirements are satisfied to permit a deduction in the full amount. The "item" here considered was included in the "gross income" of the taxpayer during the several years prior to 1958, and it appeared that it had the unrestricted right thereto. Further "a deduction is allowable for the taxable year [1958]" because the facts show that after 1957 the taxpayer did

not have the unrestricted right to "a portion of such item," and the amount of the deduction is greater than $3,000.00. Thus the tax for 1958 would be computed with "such deduction." It is apparent that the term "gross income," "exclusion," and "deduction" used in the statute have well defined meanings. The parties stipulated that the $505,536.54 had all been included in the taxpayer's "gross income" for the years 1952-57. Thus if the wording is applied without more, the appellant is entitled to the entire deduction.

Before Section 1341 was enacted, a taxpayer in appellant's position was permitted to deduct the amount of the item restored in the year it was so returned. The "claim of right" doctrine was firmly established by North American Oil Consol. v. Burnet, 286 U.S. 417. There was no alternative, however, if any remedy was sought as was held in both United States v. Lewis, 340 U.S. 590, and in Healy v. Comm'r, 345 U.S. 278. There thus existed the possibility that the taxpayer would be benefitted by the deduction over the treatment he would otherwise have received, or that he would be prejudiced. The result was then determined by a number of factors in the tax computation for the two or more years including the most obvious one—a change in tax rates. Thus the taxpayer in the pre-Section 1341 period was at the mercy of the circumstances with no choice given to him. The above cited cases establishing and refining the "claim of right" rule also reiterated the annual accounting doctrine and asserted it must be applied despite inequities which might arise from it.

For the present consideration it is sufficient to note that before Section 1341 a taxpayer by virtue of the permitted deduction could receive more benefit than the tax originally paid by him upon the "item" which had to be restored. Thus a benefit in the current year was recognized as a possibility, but not limited or related to the tax paid on the item in the previous year. It was then treated as any other deduction for these purposes in the year of restoration.

The change in "law" by the statutory enactment of Section 1341, considering the wording alone, was by the addition of the provision in subsection (a) (5) directed to those taxpayers who would suffer a disadvantage by the use of a current year deduction. This prejudice was removed by permitting the recomputation of taxes for the current year without the deduction and then a reduction of the tax so computed by the amount of tax attributable to the use of the restored amount in the earlier year if such a route would result in a lesser tax than would a current year deduction. The alternative recomputation provision appears in subsection (a) (5), and the current year deduction is recognized in (a) (4), as it existed before in a non-statutory form. It must be assumed that Congress had a real purpose in enacting the new remedy in (a) (5), and that it was to afford some needed relief in giving the taxpayer an alternative. There is nothing in the enactment itself to indicate an attempt to change the current year deduction remedy.

Thus it appears that Congress by Section 1341 enacted the existing rule as to current year deductions,

and added another and new provision whereby the taxpayer who qualifies can always receive a tax benefit from the deduction at least equal to the tax on the item when added to income, "and may receive a tax benefit of a greater amount." 2 Mertens, Law of Federal Income Taxation 340, ch. 12, § 12.106a (Zimet & Stanley Rev.). Thus it must be concluded that Congress sought to make no change in the current year deduction remedy, but only added the recomputation provision. The statutory enactment may have been precipitated by the strict application of the annual accounting rule in cases such as Healy v. Comm'r, 345 U.S. 278, 14 Oil & Gas Tax Quarterly 70.

The trial court found that the section was unclear or ambiguous, and resorted to the legislative history of the enactment of Section 1341. We do not decide whether or not the resort to the history was proper, or whether the wording is without such ambiguity. The legislative history leads to the same conclusion as does the examination of the preexisting state of the law and the statutory language described above.

The cases permit the examination of transactions taking place in prior years to identify or to characterize transactions in the current year. Arrowsmith v. Comm'r, 344 U.S. 6 (a pre-Section 1341 case), is an example. This may be done without violating the annual accounting principle, and a form of it appears in subsection (a) (5); however, we see no reason in the Act to reexamine the prior years' transactions in the case before us. The statute in subsection (a) (4), with which we are here concerned, does not require or indicate in any way that this be done.

The Government places great reliance on O'Meara v. Comm'r, 8 T.C. 622, 1947. There the taxpayer reported as income certain royalties received from oil production. He was later found by a court not to have title to the lease or land and had to repay the amounts received. This factor is an obvious distinction from the case at bar. There the question became whether the taxpayer was entitled to any deduction at all in the current year. See also Parr v. Scofield, 185 F.2d 535 (5th Cir.). The Tax Court in O'Meara held the taxpayer was entitled to a deduction in the current year of the amount repaid less the depletion allowance. The point with which we are here concerned is not developed in the opinion as the court does not indicate how the deduction for depletion should be applied. In any event the subsequent enactment of Section 1341 without stating any conditions or adjustments makes the cited case of doubtful authority.

To apply the rule sought by the Government would require the imposition of a limitation on the use of Section 1341(a) (4) determined by the amount of taxes paid by appellant in the prior years. There was no limitation or adjustment required in the doctrine expressed in (a) (4) before its enactment, and none is indicated in the statute. There appears to be no relationship established by Congress between (a) (4) and the prior year's computation other than those expressed in the Act, none of which are here pertinent. The Section only requires the tax for the current year to be figured "with such deduction."

There is no authority to permit a readjustment of the depletion allowance of the prior years nor may

later happenings alter it. Hugoton Production Co. v. United States, 349 F.2d 418 (Ct.Cl.).

Further there is no indictation that the source of the dollars used in the repayment was to be considered before Section 1341 (a) (4) nor thereafter, any more than the source of the dollars used for other deductions.

Much could be written on the subject of general policy about the result of this application of the statute without a judicial addition of conditions. This is however a specific, narrow statutory provision for a particular set of circumstances, and no broad general policy of Congress is indicated. The words used in the section have a clearly recognized meaning in the tax field, and the whole section is consistent when applied as its words direct. The refund problem and depletion was well recognized at the time of the statutory enactment.

The benefit which may accrue to the appellant is large, and thus it is different from previous instances where the benefit was small although well recognized; however, we see no reason to make a distinction based on the amount of money involved to override the statutory provisions. The trial court made no such distinction, but instead indicated that the general principles and the O'Meara case led to an addition of requirements not expressed in the statute. We cannot agree with this either, as the mandate of Congress is clear.

REVERSED.

APPENDIX B

TWENTY-FIFTH DAY, MARCH TERM, THURSDAY, APRIL 20th, 1967.

Before Honorable Alfred P. Murrah, Chief Judge, and Honorable Delmas C. Hill and Honorable Oliver Seth, Circuit Judges.

SKELLY OIL COMPANY, APPELLANT

8822 *vs.*

UNITED STATES OF AMERICA, APPELLEE

Appeal from the United States District Court for the Northern District of Oklahoma.

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Oklahoma and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the judgment of the said district court in this cause be and the same is hereby reversed, and that this cause be and the same is hereby remanded to the said district court for further proceedings in accordance with the views expressed in the opinion of the court.

APPENDIX C

Before Honorable Alfred P. Murrah, Chief Judge, and Honorable Delmas C. Hill and Honorable Oliver Seth, Circuit Judges.

SKELLY OIL COMPANY, APPELLANT

8822 *vs.*

UNITED STATES OF AMERICA, APPELLEE

Appeal from the United States District Court for the Northern District of Oklahoma.

It is ordered that the petition for rehearing is granted and that this cause be set for re-argument July 13, 1967.

It is further ordered that the judgment of this court entered April 20, 1967, is vacated.

APPENDIX D

Filed, United States Court of Appeals, Tenth Circuit, April 3, 1968, William L. Whittaker, Clerk

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UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

No. 8822—MARCH 1968 TERM

SKELLY OIL COMPANY, APPELLANT

v.

UNITED STATES OF AMERICA, APPELLEE

ON PETITION FOR REHEARING

Robert J. Casey, New York City (Thomas E. Tyre, John A. Craig, and Clark, Carr & Ellis, New York City, of Counsel, with him on Brief in Regard to Appellee's Petition for Rehearing), for Appellant.

Myron C. Baum, Attorney, Department of Justice, Washington, D.C. (Mitchell Rogovin, Assistant Attorney General, Lee A. Jackson, Loring W. Post, Attorneys, Department of Justice, Washington, D.C., with him on Petition for Rehearing), for Appellee.

Before MURRAH, Chief Judge, HILL and SETH, Circuit Judges.

SETH, Circuit Judge.

Opinion on Rehearing

The appellee filed a petition for rehearing which was granted. Additional briefs were submitted and oral argument was heard.

The parties, for better or worse, agreed during the litigation that 26 U.S.C. § 1341(a)(4) was the applicable provision. The case was tried on this basis and so presented to this court.

On rehearing, as well as on the original presentation, the Government urges that the case of O'Meara v. Comm'r, 8 T.C. 622 (1947), is determinative of the issue. The Government also urges that a construction of the section contrary to their position is not in accordance with the "spirit" of the legislation.

We are not prepared to rest this decision on the "spirit" of this portion of the statute. The rules of statutory construction are well established, and we are faced with a clearly worded section which refers to a very narrow point. This is not a provision referring to a matter of broad scope. Under these circumstances we must take it at face value.

The continued reliance by the Government on O'Meara v. Comm'r, 8 T.C. 622 (1947), is of little assistance, but it is understandable. It is obviously part of the pre-statute (1954) case law on this point, but if it did develop any new condition, such a condition was not carried over into the present section of the law. The matter of refunds of this character was well known when the statute was enacted, and we must assume that if Congress intended to create a condition as to the applicability of the section, it would have done so.

The O'Meara case does not purport to define "deductions" or anything else. This term, and the others here concerned, were defined by a myriad of cases where the issue was involved, both before and after O'Meara. Thus O'Meara was obviously part of the case law, but nothing it decided was incorporated in the statute nor influenced the construction of established tax terminology.

As stated in the original opinion, under these circumstances we cannot add a condition to the statute expressly or by a redefinition of terms, although we might wish to do so in view of the results. It is apparent that some remedial steps should be taken, but we cannot do so.

We adhere to our original opinion and dispostion of the case. REVERSED.

HILL, Circuit Judge, Dissenting.

This is a close and difficult case and one that has caused each member of the panel to burn some midnight oil. After the case was first submitted to us I agreed with my brothers that by a strict interpretation of 26 U.S.C. § 1341(a)(4) appellant was entitled to prevail and the opinion of the court was so written. Thereafter, and by a unanimous vote, a petition for rehearing was granted and the case was reargued. I then became convinced that our original decision was not correct and that the trial court should be affirmed. Therefore, I must now respectfully dissent.

I believe the trial judge was correct in reasoning that § 1341(a)(4) did not create a new deduction

and that thus the O'Meara decision [1] applied in the determination of the deduction allowable. The majority fails to present any reason for divorcing the determination of the deduction from its initiating basis.

The cornerstone of appellant's argument and the position apparently accepted by the majority is that "the statute utilizes interchangeably the phrase 'item included in gross income in prior year' with the term 'deduction.'" It is my contention that these two phrases are not used interchangeably and that a more reasonable interpretation of the statute is that the "deduction" to be allowed may in appropriate situations differ significantly from the item included in gross income. At no time does the majority define "deduction" as it is used in § 1341. It is, however, asserted that "deduction" has a well defined meaning. This can only refer to the meaning developed in pre-1341 cases dealing with the problem of refund of prior "claim of right" income. Indeed the majority recognizes that "the current year deduction is recognized in (a)(4) as it existed before in a non-statutory form." However, the majority's further statement that prior to the enactment of § 1341 "a taxpayer in appellant's position was permitted to deduct the amount of the item restored in the year it was so returned" without any reference to the O'Meara decision is misleading to say the least and is undoubtedly the crucial error in the majority's reasoning. O'Meara is bypassed by my distinguished brothers with the statement that "The point with which we

[1] Maurice P. O'Meara, 8 T. C. 622 (1947).

are here concerned is not developed in the opinion as the court does not indicate how the deduction for depletion should be applied. In any event the subsequent enactment of Section 1341 without stating any conditions or adjustments makes the cited case of doubtful authority."

To me it is much more reasonable to say that the existence of O'Meara in the case law pre-dating the enactment of § 1341 means that it must be considered as a part of the definition of "deduction" that arises from the case law. Certainly an examination of O'Meara shows that the court considered the problem of the effect of taking a prior depletion deduction on claim of right income which was later returned. The O'Meara case concerned a suit for refund of taxes which had been previously paid by O'Meara on royalties received from certain oil properties which had been acquired by O'Meara by warranty deed. During the years when such income was included O'Meara had taken the allowable depletion allowance on such royalties. Subsequently as a result of litigation O'Meara was held to have had unlawful possession of the mineral properties and was required to pay over all royalties received from such property. On his later return O'Meara deducted the amount so repaid and this deduction was disallowed by the Commissioner. The Tax Court reversed the Commissioner's rule and allowed the deduction,[2] limiting it and re-

[2] It is interesting to note that in 1341(a)(1) the term "an item included in gross income" is used as a requirement for the application of the statute. This same requirement was established in O'Meara, supra, to be the sole requirement

ducing it by the amount that O'Meara had previously taken as a depletion allowance.

Concerning the problem of reduction of the allowable deduction the court in O'Meara stated:

> "[T]he amount of loss for which petitioner is entitled to the deduction must be limited by the amount of the royalty income reported for tax purposes after deducting for depletion. It makes little difference whether the depletion deduction be viewed as a diminution of income, thereby resulting in effect in a reporting by petitioner of only the net amount of 72½% of the royalties received rather than 100%, or whether we recognize that the depletion deduction is permitted to one in the position of the owner of the oil in place or of a depletable interest therein, and that when it developed that petitioner was not the owner the deduction became erroneous, and petitioner is required to include the deducted amount as income in the year when that situation appears; see Douglas v. Commissioner, 322 U.S. 275; or whether the adjustment is viewed as required by the statutory definition of basis. Section 113(b)(1)(B), I.R.C. See Virginia Hotel Corp. v. Helvering, 319 U.S. 523. In any event, the net amount of the loss for which petitioner is entitled to take a deduction is the total of the royalties reported less the amount deducted for depletion." O'Meara, supra, at 634-5.

Appellant asserts that only the second of the above mentioned grounds for the reduction is valid; since

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for the establishment of a basis for later gains or losses. As discussed later there is, however, a significant difference between establishing a basis and allowing the full amount as a deduction.

in the instant case there was no question but that Skelly was at all times the legal owner of the land the O'Meara case is distinguishable and not applicable to the instant case. Apparently the court in O'Meara, however, felt that any of the above three mentioned grounds would be sufficient to uphold the government's argument that the deduction should be reduced by the amount of the depletion deduction previously taken.

I suggest that O'Meara stands for the basic principle that a basis established for gain or loss by the inclusion of income under a claim of right, which income has been the basis for a percentage depletion deduction, must be limited by that amount of the directly related deduction,[8] and that the reasoning and

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[8] A short analysis of the depletion deduction shows its direct relation to the gross income produced from a well and illustrates further why in recognizing a deduction for return of such income cognizance must be given the percentage depletion deduction.

A depletion deduction is allowed a taxpayer whose income results from production from a natural resource. In receiving such income the natural resource is depleted, thus depleting the taxpayer's capital investment. In computing other forms of income, i.e., such as a manufacturer's income, the capital investment of the manufacturer is considered and deducted. Thus in a similar sense a depletion deduction from income received from a natural resource is allowed as a return of the taxpayer's capital. 4 Mertens, § 24.02. Such depletion allowance was originally considered on two grounds, a cost depletion and a discovery depletion. Both of these depletion allowances had a specific limit upon the total amount of depletion that could be taken; however, these depletion limitations proved somewhat unsatisfactory as they made computation of the depletion difficult. Therefore, a percentage depletion deduction was established whereby the depletion de-

applicability of the O'Meara decision is just as applicable today as it was before the enactment of § 1341. I agree entirely with Judge Daugherty when he states "Any other procedure would do violence to the spirit of the legislation and the intent of the Congress to afford equitable relief to a taxpayer who thought he had a right to keep certain of his income and paid taxes thereon but it later turns out that he had no such right and was required to restore or repay the same. Congress intended that a taxpayer should get at least equal tax benefit but cannot have intended that a taxpayer should get a deduction allowable for income on which he had not previously paid a tax because of some benefit accruing to the specific income such as a depletion allowance." In fact any other position would appear to be totally unreasonable. The resulting effect would be that two measures intended to relieve and benefit the taxpayers can combine to result in a windfall to the taxpayer greatly exceeding the benefit which might result from the separate application of these measures. That such an overall result was intended seems unlikely.

It was argued by appellant that the statement of the court in O'Meara that "the process of establishing

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duction was made a direct function of the amount of income received from the natural resource. 4 Mertens, § 24.04. There is no limitation on the amount of depletion deductions which may be taken over a period of years such as with the cost of depletion or like the depreciation allowance allowed for the equipment used by a manufacturer. It is clear in fact that the total depletion deduction taken from a natural resource could far exceed the total cost of the natural resource. Commissioner v. Southwest Exploration Co., 350 U.S. 308.

a basis for an income item consists * * * of reporting it in the taxpayer's gross income * * *" Id. at 633, required that no further consideration be given to any depletion deduction taken from said income in the computation of the deduction allowable in the year of the repayment. The Tax Court in making this statement, however, was not considering the problem of the amount of deduction allowable but merely that the government did not have to receive any tax benefit from the inclusion of the income in the return in the prior year. The mere reporting of the item as gross income established a basis. The court, however, did not go on to say that the entire item included in gross income would establish the amount of the basis. This was not considered until the later portion of the opinion quoted above, where the court found that the deduction allowable was not equatable with the total amount included in gross income but was limited by the depletion deduction previously taken. No inconsistency results from saying that the inclusion of an item in gross income establishes a basis for later deductions notwithstanding lack of tax benefit to the government but not allowing a taxpayer to include the entire amount included in gross income as a basis for deduction.

Consideration of the percentage depletion deduction in determining the deduction allowable under § 1341 does not violate the annual accounting concept as established by Burnett v. Sanford & Brooks Co., 282 U.S. 359, as the consideration of the prior years' returns is only for the purpose of determining the amount of the allowable deduction in the present

year's return. There is no reopening or refiguring of prior years' taxes, merely a computation of the present year's taxes. That consideration of the prior years' returns may be made is clearly established by cases such as Arrowsmith v. Commissioner, 344 U.S. 6; Douglas v. Commissioner, 322 U.S. 275; and Dobson v. Commissioner, 320 U.S. 489. Cases cited by appellant such as Healy v. Commissioner, 345 U.S. 278, concern the taxpayer's proposition that the tax for the prior years be recomputed and that refunds be made from the taxes paid in the prior years. This situation is clearly not the one before us in the instant case. Here, as mentioned above, we are merely determining the amount of the allowable "deduction" in the present taxpaying year. The majority cites the case of Hugoton Production Co. v. United States, 349 F.2d 418, as authority for the proposition that consideration may not be given of the prior taxpayer years. The Hugoton case, however, is not direct authority for this proposition. That case involved the determination of the price received by similarly situated producers for purposes of establishing wellhead prices for depletion allowances. In the computation of such prices, the court stated that it could not consider refunds made by such other producers under situations similar to that of the instant case and gave as its reasons for not considering such refunds the annual accounting concept. The court went on to note, however, that such refunds would be reflected in any respect as they were considered in the subsequent years when the repayments were made. It should suffice for the Hugoton case to say that the

question considered by the court there was not the question which we are considering in the instant case. One could go on to question, however, whether the application of the annual accounting concept to the situation found in the Hugoton case required the result reached by that court. In any respect it is reasonable to say that consideration of prior depletion deductions allowed in computing a "deduction" allowable under § 1341(a)(4) for a current tax year is not a violation of the annual accounting concept.

In summary, the deduction for refunded claim of right income as originally established by case law and continued by § 1341 was to provide relief for a taxpayer from the application of the strict claim of right doctrine. It is unreasonable to transfer such relief into a windfall for the taxpayer unless such a result is clearly and unavoidably required. A double deduction should not be given unless there is virtually no alternative. Here I believe the more reasonable decision to be to limit appellant's allowable deduction by the amount of percentage depletion deduction previously claimed.

APPENDIX E

MARCH TERM, WEDNESDAY, APRIL 3rd, 1968.

Before Honorable Alfred P. Murrah, Chief Judge, and Honorable Delmas C. Hill and Honorable Oliver Seth, Circuit Judges

SKELLY OIL COMPANY, APPELLANT

8822 *vs.*

UNITED STATES OF AMERICA, APPELLEE

Appeal from the United States District Court for the Northern District of Oklahoma.

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Oklahoma and was argued by counsel on January 10, 1967. On April 20, 1967, an opinion was filed reversing the judgment of the district court and remanding the cause to the said district court for further proceedings in accordance with the views expressed in the opinion of the court, and on that same date judgment in accordance with the opinion was entered. Thereafter on June 26, 1967, appellee's petition for rehearing was granted, the judgment of April 20, 1967, was vacated, and the cause was reargued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the judgment entered on April 20, 1967, be and the same is hereby reinstated

and the judgment of the said district court is reversed and the cause remanded to the district court for further proceedings in accordance with the views expressed in the opinion of the court.

Honorable Delmas C. Hill, Circuit Judge, dissented.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1968

UNITED STATES OF AMERICA,
Petitioner,

v.

SKELLY OIL COMPANY.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR SKELLY OIL COMPANY IN OPPOSITION

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1968

No. 280

UNITED STATES OF AMERICA,

Petitioner,

v.

SKELLY OIL COMPANY.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR SKELLY OIL COMPANY IN OPPOSITION

Opinions Below

The findings of fact, conclusions and decision of the district court are reported at 255 F. Supp. 228. (R. 20-30)[1] The initial opinion and opinion after rehearing of the court of appeals are reported in 392 F.2d 128.

Jurisdiction

The initial judgment of the court of appeals was entered on April 20, 1967. The petition of the United States for a rehearing was granted on June 27, 1967 and reargument was held on July 13, 1967. The judgment upon rehearing was entered on April 3, 1968. (Pet. App. E, pp. 24-25) On July 2, 1968 the time for filing a petition for

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[1] "R" references are to the printed record in the Court of Appeals.

a writ of certiorari was extended to and including July 9, 1968. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

Question Presented

Where respondent, a producer of natural gas, produced and sold the mineral during the years 1952 through 1957, and the sale price thereof entered into the computation of its depletion allowance, and in 1958, pursuant to a lawsuit, it was required to repay a portion of said sales price, does Section 1341(a)(4) of the Internal Revenue Code of 1954 require that its otherwise allowable ordinary and necessary business expense deduction be adjusted so as to reflect the previously allowed depletion allowance? The Court below, after exhaustive consideration, held that it does not.

Statute and Regulation Involved

Internal Revenue Code of 1954:

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) *General Rule*—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. For purposes of this part, the term "mines" includes deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under section 613(c). In any case in which it is ascertained as a result of operations or of develop-

ment work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.

* * *

(26 U.S.C. 611.)

SEC. 613. PERCENTAGE DEPLETION.

(a) *General Rule.*—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

(b) *Percentage Depletion Rates.*—The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

(1) 27½ percent—oil and gas wells.

* * *

(26 U.S.C. 613.)

SEC. 1341. COMPUTATION OF TAX WHERE TAXPAYER RESTORES SUBSTANTIAL AMOUNT HELD UNDER CLAIM OF RIGHT.

(a) *General Rule*—If—

(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;

(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

(3) the amount of such deduction exceeds $3,000, then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

(4) the tax for the taxable year computed with such deduction; or

(5) an amount equal to—

(A) the tax for the taxable year computed without such deduction, minus

(B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).

* * *

Treasury Regulations on Income Tax (1954 Code):

§ 1.1341-1 *Restoration of amounts received or accrued under claim of right.*—(a) *In general.*—(1) If, during the taxable year, the taxpayer is entitled under other provisions of chapter 1 of the Internal Revenue Code of 1954 to a deduction of more than $3,000 because of the restoration to another of an item which was included in the taxpayer's gross income for a prior taxable year (or years) under a claim of right, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year shall be the tax provided in paragraph (b) of this section.

* * *

(b) *Determination of tax.* (1) Under the circumstances described in paragraph (a) of this section, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year shall be the lesser of—

(i) The tax for the taxable year computed under section 1341(a)(4), that is, with the deduction taken into account, or

(ii) The tax for the taxable year computed under section 1341(a)(5), that is, without taking such deduction into account, minus the decrease in tax * * * for the prior taxable year (or years) which would result solely from the exclusion from gross income of all or that portion of the income included under a claim of right to which the deduction is attributable. * * *

* * *

(26 C.F.R. 1.1341-1.)

Statement

The material facts may be summarized as follows:

Respondent, Skelly Oil Company, produces and sells natural gas in Oklahoma and was so engaged in 1952 when the Oklahoma Corporation Commission established a minimum price for sales of natural gas at the wellhead. (R. 21) This order raised the price of the gas respondent was selling under pre-existing contracts with Cities Service Company and Dorchester Corporation. (R. 22) The minimum price order was ruled invalid in *Michigan Wisconsin Pipeline Co.* v. *Corporation Commission of Oklahoma,* 355 U.S. 425 (1958), and was subsequently vacated. (R. 22)

In computing its depletion allowance for each of the years 1952 through 1957, Skelly had included in its "gross income" and in its "gross income from the property" the amounts charged under the invalidated minimum price order. (R. 23-25)

In 1958, Cities Service Company sued Skelly for $777,853.25, representing alleged overcharges for natural

gas purchased by it from Skelly between August 1, 1952 and December 22, 1957. (R. 22). Also in 1958, Dorchester Corporation, which sold gas to Northern Natural Gas Pipeline Company of America for Skelly's account, was required, due to the invalidation, to repay Natural Gas Pipeline Company for alleged overcharges and it sought reimbursement from Skelly. (R. 24)

In October and November, 1958, Skelly paid $5,536.54 to Dorchester Corporation and settled the lawsuit brought by Cities Service Company by paying Cities $500,000. (R. 22, 24) On its Federal tax return for 1958 Skelly took a business expense deduction for the $505,536.54 which it had paid to Dorchester and Cities Service. (R. 25)

Upon audit of Skelly's Federal tax return for 1958 the Internal Revenue Service reduced Skelly's otherwise allowable depletion allowance on its mineral production *for 1958* by $139,022.55, representing 27½ percent of the $505,536.54 deducted on the return. Skelly paid the resulting assessment and filed a claim and later a suit for refund. (R. 25)

The only issue presented to the trial Court was whether, in computing Skelly's liability for Federal income tax for the taxable year ending December 31, 1958 under the provisions of Section 1341(a)(4) of the 1954 Internal Revenue Code, it was proper to reduce its otherwise allowable percentage depletion for the taxable year by $139,022.55 representing 27½ percent of $505,536.54, the purchase price received by it from the sale of natural gas during prior taxable years, which purchase price had been included by it in gross income for such prior taxable years under a claim of right without restriction as to use, and which it was required to restore to the payors thereof during the taxable year ending December 31, 1958; or, in the alternative, whether Skelly was required to reduce its otherwise allowable deduction under Section 1341(a)(4) of $505,536.54 by 27½ percent, or $139,022.55, to reflect percentage depletion previously claimed and allowed thereon in its Federal income tax returns for the years in which such

amount was taken into gross income under a claim of right without restriction as to use. (R. 12, 20)

The Trial Court held that Skelly was entitled to a deduction in 1958 of only $366,513.99 on account of the $505,536.54 payment (R. 29), but the Court of Appeals unanimously reversed holding that no legal authority supported the decision. (Pet. App. A, pp. 1-10) After granting a rehearing, the Court of Appeals reiterated its prior decision with one judge dissenting. (Pet. App. D, pp. 13-23)

Summary of Argument

The issue in this case is a very narrow one, dependent in its scope upon the peculiar circumstances of a particular taxpayer.

The Court below, after careful consideration and reconsideration, correctly held that under all judicial authority except for one obscure pre-1954 case, and under the clear mandate of Section 1341 of the Internal Revenue Code of 1954 and the intention of Congress in enacting the section, respondent, Skelly Oil Company, was entitled to take a deduction in 1958 for amounts paid out in settlement of litigation even though said litigation involved amounts received in prior years from the sale of minerals upon which a depletion allowance was afforded by law.

No double deduction is involved because two separate economic transactions are involved.

Under the annual accounting concept a "transactional" approach to the question is forbidden.

In any event, the issue is of little importance to the administration of the revenue laws because its impact depends upon the effect of the entire Section 1341 on an individual taxpayer, and the Government itself in similar circumstances has refused to apply the "tax equalization" rule it here asks this Court to create.

Respondent contends that the uniformity and symmetry of the Internal Revenue Code should not be destroyed because one taxpayer received a benefit therefrom.

Argument

1. The decision of the Court below is unanimously supported by all principles of tax accounting and by all legal authority.

The most fundamental concept of taxation, and the essence of our system of taxation, is that income and deductions must be determined on an annual basis. The doctrine was established by this Court in *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359 (1931), and further elaborated upon and strengthened in *North American Oil Consolidated* v. *Burnet*, 286 U.S. 418 (1932), *United States* v. *Lewis*, 340 U.S. 590 (1951), and *Healy* v. *Commissioner*, 345 U.S. 278 (1953). Most recently, this concept was flatly reaffirmed in *Commissioner* v. *Gordon*, — U.S. — (United States Supreme Court, Nos. 760, 781, Oct. 1967 Term, decided May 20, 1968), when this Court stated at page 12:

> "Absent other specific directions from Congress, code provisions must be interpreted so as to conform to the basic premise of annual tax accounting. It would be wholly inconsistent with this premise to hold that the essential character of a transaction, and its tax impact, should remain not only undeterminable but unfixed for an indefinite and unlimited period in the future, awaiting events that might or might not happen."

The annual accounting approach was established in *Burnet* v. *Sanford & Brooks, Co., supra,* because of its ease of application and its production of revenue at regular intervals. In doing so the Court specifically rejected the "transactional" approach or method which would postpone the assessment of the tax, until the transaction giving rise to income or deduction is finally concluded, to the end of a lifetime or for some other indefinite period.

In *North American Oil Consolidated* v. *Burnet, supra,* it was established that if a taxpayer receives income under

claim of right he must report it as income even though it subsequently develops that its equivalent must be restored. *United States* v. *Lewis, supra,* established that in such circumstances, the taxpayer, if he was entitled to any deduction, was limited to a deduction of the amount restored only in the year of restoration. *Healy* v. *Commissioner, supra,* made it clear that the deduction must be the amount restored and is not to be limited to the *tax* paid when the restored item was originally received. It was recognized that the application of the rule could result in either a benefit or a burden to the taxpayer or to the Government.

Petitioner concedes this annual accounting principle (Pet., pp. 7, 8), states it, and then proceeds to ignore it. The Court below recognized that the application of the annual accounting rule benefited this particular taxpayer, but held that such benefit is consistent with the scheme of our taxation system. The petitioner would have this Court abort these long-established principles and grant relief in this case *despite the law.* This should not be done.

No "loss" predicated upon a single transaction is involved in this case. The gas was produced and sold over a five-year period. Such a "transactional" contention was rejected completely in *Burnet* v. *Sanford & Brooks Co., supra.* Respondent here was sued for over $700,000 and settled the litigation by paying $505,536. This *payment* is deductible under Section 162 of the Code as an ordinary and necessary business expense of the year 1958 and not as a loss. *Kornhauser* v. *United States,* 276 U.S. 145 (1928); *Welch* v. *Helvering,* 290 U.S. 111 (1933); *Commissioner* v. *Tellier,* 383 U.S. 687 (1966). No provision of the Revenue Code or judicial or regulatory authority requires or permits the tracing of the amounts paid out in 1958 back to the years 1952 through 1957 so as to eliminate from the deductible amount the depletion allowance legally permitted when equivalent amounts were received from the production and sale of gas.

The case of *Arrowsmith* v. *Commissioner,* 344 U.S. 6 (1952), is not to the contrary. That case stands for the

proposition that the *nature* of a proposed deduction, i.e., whether it is a capital or ordinary, *or even allowable at all,* may be determined by reference to the facts giving rise to the *repayment,* but it does not permit the facts of the original receipt to be reevaluated and the tax consequences thereof to be redetermined. *National Life & Accident Ins. Co.* v. *United States,* 244 F. Supp. 135, 139 (M.D. Tenn. 1965), aff'd on other issues, 385 F.2d 832 (C.A. 6th 1967). *Arrowsmith* had nothing to do with the *amount* of the deduction. The fact is that in *Arrowsmith* there could have been no deduction at all under the Code unless it was a capital loss deduction. In the instant case the *amounts* paid clearly qualified as ordinary and necessary expense deductions and have only an incidental relation to the depletion allowance in prior years. *Kornhauser* v. *United States, supra.* Petitioner has in fact stipulated, and does not now dispute that the amount is otherwise deductible unless limited by Section 1341.

The repayment in this case was because of money previously received but the prior depletion allowance was not involved in the litigation. Respondent was not sued because it took a depletion allowance to which it was not entitled. It was sued for damages on account of overcharges resulting from the minimum price statutes. But respondent produced and sold the gas in 1952 through 1957 and was entitled to the depletion allowance. The repayment arose out of the lawsuit for overcharging and was not based upon an allegation of lack of title to the mineral.

There is no provision of tax law that requires that all deductions for business expenses paid out of the *proceeds* from the production and sale of minerals, upon which a depletion allowance was once secured, must be reduced by the amount of depletion previously allowed. That, however, is the basic thrust of petitioner's contentions. The characterization of the deduction as a "loss deduction," in an attempt to avoid the impact of the annual accounting

rules, and thus subliminally superimpose on the issue the long discredited transactional approach, does not strengthen petitioner's cause.

The fact is that respondent produced and sold the mineral, and was entitled to the depletion allowance under the law. In a later year it paid back some of the money it had charged for the mineral but the entire series of transactions occurring between 1952 and 1958 cannot now be reconstituted as if they never happened. The law specifically prohibits such procedure.

The analogy of a dividend transaction between domestic corporations is not in point for the simple reason that, upon repayment, the receiving corporation would not be entitled to any deduction at all, as the repayment would not be a deductible expense but a contribution to capital. See *Walter E. Kramer* v. *Commissioner*, 27 B.T.A. 1043, 1048 (1933).

What petitioner proposes is the engrafting of a new rule of law onto the Internal Revenue Code so as to enable it to prevail in *this case only*. It is contending that the otherwise allowable *deduction* of $505,656, which the respondent without question *paid out*, must somehow be adjusted so as to equalize the *tax* for one year (1958) with the *tax* paid in 1952 through 1957 on amounts which totaled $505,656. This is impossible unless Section 1341(a)(4) of the Code somehow created a new definition of the current year's deduction, which it did not. Compare Sections 1341(a)(4) and 1341(a)(5). Presumably petitioner proposes to do this *solely* in this case because it is satisfied that the adjustment proposed would, in fact, equalize the tax. But that would not necessarily be the case for other taxpayers. Should the entire symmetry and scheme of the Code be upset in order to deal with one taxpayer? This Court said "no" in *Lewyt Corporation* v. *Commissioner*, 349 U.S. 237, 240 (1955), with the following language:

> "But the rule that general equitable considerations do *not* control the measure of deductions *or* tax benefits cuts both ways. It is applicable to the Government as to the taxpayer. Congress may be strict or lavish in its allowance of deductions or tax benefits. The formula it writes may be arbitrary and harsh in its applications. But where the benefit claimed by the taxpayer is fairly within the statutory language and the construction sought is in harmony with the statute as an organic whole, the benefits will not be withheld from the taxpayer though they represent an unexpected windfall. * * *" (Emphasis supplied)

The *ad hoc* creation of an *inverse* tax benefit, or "tax equalization," rule would not sustain petitioner's contention, primarily because *no tax benefit* is involved. Compare Section 111, Internal Revenue Code of 1954. Respondent *paid out* money, it did not *recover* it. Its mineral was not restored, it is gone forever. If, as contended, the previously allowed depletion allowance were restored to income in 1958 (thus creating income where none exists) would a depletion allowance be allowed on that *created* income? It would have to be "gross income from the property" for depletion purposes or else there would be no reason for the "credit to income." By the same token, if an operating loss was experienced in the prior years, would petitioner be so apt to apply the rule it proposes in this case?

Petitioner would have this Court create a new rule of law with widespread ramifications just to penalize one taxpayer—a rule that would be engrafted upon, or replace, the tax benefit rule, and which would require *tax equalization* dependent upon the long term economic result of a transaction or group of transactions. To do so this Court would have to add a new section to the Revenue Code and overrule a long line of legal precedents that are the foundation of our taxing system. See, e.g., *American Automobile Assn.* v. *United States*, 367 U.S. 687 (1960).

It is highly improbable that the Government would, in the long run, benefit from the creation of a new tax equalization rule because it would most likely be applicable only to respondent's situation and only for this particular tax year. Other taxpayers who restored income received under claim of right might have paid *no* tax in the years of receipt, despite the allowance for depletion, or the depletion allowance may have had little economic benefit to them depending upon the area rate, the field price of the mineral and/or their costs of production. What adjustment would then be made to "equalize the tax?"

Petitioner's strenuous effort in *A. P. Sullivan Corp.* v. *United States,* 381 F.2d 399 (Ct. Cls. 1967), to persuade the Court of Claims to overrule a "tax equalization" doctrine enunciated in *Perry* v. *United States,* 160 F. Supp. 270 (Ct. Cls. 1958), vitiates the validity of its petition to this Court in the instant case.

2. The purpose and intent of Section 1341(a)(4) of the Revenue Code supports the decision of the Court below.

The Court below did not interpret Section 1341(a)(4) as providing a "loophole" of any kind. It applied it as it is written and as it was intended to be applied by Congress. Further, it was never contended, and the Court below did not hold, that this Section created a new deduction. By the same token, it does not operate to limit a taxpayer's recovery to a *tax* no greater than the tax originally paid with respect to the restored claim of right item.

Prior to the enactment of Section 1341 as part of the 1954 Code, a taxpayer who had previously included an item in gross income under the claim of right principle of *North American Oil Consolidated* v. *Burnet, supra,* was required to take a deduction for the repayment of that item in the year of such repayment. *United States* v. *Lewis, supra,* specifically held that in the claim of right situation a taxpayer should deduct the amount which he was required

to restore *in the year of repayment* and in no other year. Congress, in enacting Section 1341, provided that under claim of right circumstances of taxpayer must *either* (1) take a deduction for the year of repayment, *or* (2) recompute his tax for the year of receipt by excluding the receipt, *whichever produces the greater benefit.* No *option* is involved! The section is *mandatory.* The clear truth is that Congress sought to and did remove the *burden* on the taxpayer resulting from the application of *United States* v. *Lewis, supra,* while preserving to taxpayers the *benefits* which were recognized as possible under that decision.

Contrary to the assertions in the petition, it was not the intent of Congress to overrule completely the rule of law enunciated in *Lewis* and *Healy.* The Committee Reports clearly explain that the purpose of Section 1341 was to ameliorate *one* of the aspects of those cases and leave the others as provided by existing law. And prior law did *not* deny the deduction allowed in the instant case—it required it. Senate Report No. 1622, 83d Cong. 2d Sess., pp. 118, 451, specifically points out that:

> "Under present law if a taxpayer is obliged to repay amounts which he had received in a prior year and included in income because it appeared that he had an unrestricted right to such amounts, he may take a deduction in the year of restitution. In many instances of this nature, the *deduction* allowable in later years does not compensate the taxpayer adequately for the tax paid in the earlier year.
>
> * * *
>
> "If the taxpayer included an item in gross income in one taxable year, and in a subsequent taxable year he becomes entitled to a deduction because the item or a portion thereof is no longer subject to his unrestricted use, and the amount of the deduction is in excess of $3,000, the tax for the subsequent year is reduced by *either* the tax attributable to the deduction or the decrease in the tax for the prior year attributable to the removal of the item, *whichever is greater.* Under the rule of the *Lewis* case (340 U.S.

590 (1951)), the taxpayer is entitled to a deduction only in the year of repayment." (Emphasis supplied.)

Under the rule espoused by petitioner there would be no alternatives. The tax effect of repayment would always be commensurate with the prior *tax* paid. Thus, Section 1341(a)(4) would be vitiated.

The adjustment-of-*tax*-for-the-year-of-repayment method, which the petitioner sought to sustain in the Court below, has been rejected by Congress many times. [See, Statement of Ellsworth C. Alvord, Hearings on H.R. 7378 Before the Senate Committee on Finance, 77 Cong. 2nd Sess. 1784 (1942); American Law Institute, Federal Income Tax Statute, Sections X332, X333 (Feb. 1954 draft).] Moreover, while seeking such judicial amendment to the Revenue Code in this case, the petitioner was simultaneously urging the Court of Claims to *apply* the very principle of the instant case where that application redounded to *its benefit*, even though such result overruled a long-standing precedent. See and compare, *A. P. Sullivan Corp.* v. *United States, supra,* overruling *Perry* v. *United States, supra.* Pointing out that the taxing statutes must be literally applied as enacted, and without reference to equitable considerations, the Government persuaded the Court of Claims to overrule its previous decision, however inequitable the result to the taxpayer. In doing so petitioner based its argument on the very principles of law relied upon by the Court below in the instant case.

If petitioner's "tax equalization" theory had any foundation in law there was no need for Congress to enact Section 1341. Thus the petition for certiorari asks this Court to invalidate Section 1341 of the Internal Revenue Code of 1954, or at the very least, subsection 1341(a)(4) thereof.

The contention that the Court below "confused" the terms "item" and "deduction" by regarding them as having the same meaning is a pseudo-intellectual exercise

without foundation in fact. It did not do so. The Court below concerned itself with whether the *deduction* referred to in Section 1341(a)(4) must be limited by the *tax* paid in prior years, and concluded that under all legal authority and legislative history it was not, and was never intended to be so limited. As a matter of law, Section 1341(a)(5), which petitioner would have the Court substitute for Section 1341(a)(4), requires only that the "item" referred to be previously included in "gross income." But the *full amount* of the proceeds from the sale of gas were reported in "gross income" by respondent! The depletion allowance has no relation to "gross income" but rather to "gross income from the property"—terms of art in the field of taxation which are not synonymous. See Revenue Ruling 60-344, 1960-2 CB 186. The Treasury Department often applies the distinction to maximize the collection of revenue.

The truth is that Congress has devised an orderly, uniform method for dealing with questions such as are involved in the instant case. Petitioner has no compunctions about strictly applying the letter of the law to taxpayers when the result is to its benefit. See *A. P. Sullivan Corp.* v. *United States, supra;* see also, *Income Tax-Recovered Property Previously Deducted Included in Gross Income in Year of Recovery,* 66 Michigan Law Review 381 (No. 2, December 1967), especially footnotes 19, 24, 25.

But "(t)he basic principle cannot be changed simply because it is of advantage to a taxpayer or to the Government in a particular case that a different rule be followed." *Healy* v. *Commissioner, supra,* at pages 284-285.

Under the statutory scheme of the Revenue Code there are at least eleven situations in which the application of Section 1341(a)(4) will result in a benefit to taxpayers. Petitioner has not challenged these benefits except in the instant case which involves the depletion allowance, even though such benefits have been apparent for many years. There are probably as many situations where the results are detrimental to taxpayers. It is submitted, however,

that the law must be evenly applied and the entire statutory scheme and all case law cannot be abrogated in order to penalize *one taxpayer*. See discussion of administrative importance and ripeness for review, *infra*, pages 19-22. It must also be remembered that the recipients of the amounts paid by respondent must include the *total* amount paid in their gross income. Any reshuffling of the statutory scheme may thus involve not only Section 1341 but other sections of the Code as well. Such overall reformation, even if desirable, is the task of Congress, not of the Courts.

Actually, the scope of the decision below is very limited. The decision is not one of broad application or uniform impact; whether it benefits or burdens a taxpayer depends upon the specific circumstances in each case. See discussion, *infra*, at pages 19-22. For example, if a loss had been incurred by respondent in the year of receipt despite the depletion allowance, resulting in no tax benefit, would the petitioner advance this "tax equalization" theory? If the properties which produced the mineral had been abandoned in the interim, could the "transactional" argument still be made? It is submitted that the narrow issue raised by the Government in this case is not ripe for review by this Court. Too many questions have been left unanswered.

The Treasury Department is currently studying proposed tax legislation which may well make the issue in this case moot. See New York Times, July 21, 1968, pages 1, 24. Respondent submits that the broad overall tax reform urged upon the Court by this petition for certiorari should best be left to Congress.

3. No double deduction is involved in this case.

The assertion of "double deduction" in the petition for certiorari is specious at best and untrue at worst. No "double deduction" is involved. The fact is that respondent sold gas in the years 1952 through 1957. It was en-

titled to the depletion allowance under the law because it produced and sold the mineral. Its mineral deposit was, in fact, depleted—no question with regard to that is involved in the case. In a later year, 1958, pursuant to litigation, respondent was required to pay $505,536 to the purchasers of its gas upon the settlement of a suit for $700,000. The deduction of the amount paid out no more constitutes a double deduction for depletion than does the deduction of wage and salary expense, or any other expense of doing business where the *money used* to pay such expenses was originally derived from mineral production on which depletion was allowable under the law.

Depletion is allowed because of the production of the mineral which is a wasting asset and as long as the mineral is produced and sold the deduction is permitted under the law as a restoration of capital. Not all mineral producers are entitled to the same rate and even in the same industry the allowable amount varies widely depending upon net income from the property limitations, overhead expense, extraction and processing costs, and sales price of the mineral. Even aside from consideration of the annual accounting requirement there is a wide gulf between the depletion allowance and an ordinary business expense.

The case of *Ilfeld Co.* v. *Hernandez*, 292 U.S. 62 (1934), is not pertinent. There the Court refused to allow the taxpayer to deduct the *same economic loss twice*, because to do so would constitute the allowance of a double deduction, but the situation there is far removed from that of the instant case. There the taxpayer experienced only *one loss* and sought to deduct it twice. Here the taxpayer produced and sold the mineral and was legally and validly entitled to the depletion allowances in the years of sale because its *mineral was depleted*. In a later year it was required to pay $505,536 to the purchasers and it was legally and validly entitled to deduct the amount paid as a business expense. It thus suffered *two* losses. Its mineral was forever depleted and its $505,536 was paid out.

There is no provision of tax law that requires that the depletion allowance be continually adjusted retroactively depending upon subsequent events, as petitioner would have this Court believe.

4. The case of *Douglas* v. *Commissioner* does not support the proposition for which it is cited in the petition.

In *Douglas v. Commissioner*, 322 U.S. 275 (1944), this Court held valid a Treasury Regulation which required that depletion allowed on advance royalties, received before actual production, must be restored if the mineral lease was later cancelled and *no* production of mineral ever took place. Petitioner failed to mention, however, that that Regulation provided, and current Regulations still provide, that the depletion must be restored *only* if the lease expires, terminates or is abandoned before *any* production is attained. If *any* mineral is produced, however, no matter how much, no restoration of depletion is required. See, Treasury Regulations Secs. 1.612-3(a)(2), 1.612-3(b)(2); *Dolores Crabb* v. *Commissioner*, 41 B.T.A. 686 (1940); *Waggoner* v. *Commissioner*, 47 B.T.A. 699 (1942), acquiescence 1945 CB 7; Revenue Ruling 1968-78, I.R.B. 1968-7, 18. In the instant case there was no failure of production and the leases did not expire or terminate and were not abandoned. The mineral which gave rise to the depletion allowance was produced and sold and Respondent has continued to produce minerals from all of the properties involved. Respondent did not recover the *mineral* sold in prior years or any rights thereto. It is gone forever.

The *Douglas* rule thus holds that if production is never obtained and, therefore, no depletion of the mineral occurs, the depletion allowance previously deducted must be taken into income. *But* if some production is obtained no restoration is required because the original amount received constitutes the sales price of, and hence the gross income from, the production of the mineral. This is the only workable rule. Otherwise a *hypothetical* value, for depletion

purposes, not based upon "gross income from the property" would have to be established for all minerals by the Treasury Department in each producing area throughout the world. This would be directly contrary to the Revenue Code.

5. This case is of no administrative importance and is not ripe for review by this Court.

Petitioner's allegations that large amounts of revenue will be jeopardized as a result of this decision and the decisions in the natural gas rate cases under the jurisdiction of the Federal Power Commission, is without foundation.

In the first place, the Federal Power Commission has jurisdiction over sellers and transporters of gas as well as producers, and *customer* refunds may have little or no tax effect when and if some amount thereof filters back to producers—the only party entitled to a depletion allowance. Even in that event, whether or not a given producer would be affected by the application of the petitioner's new "tax equalization" theory, would depend upon its peculiar circumstances, such as overhead expense, cost of production, profit or loss, etc., in both the year of production *and* the year of repayment. See and compare Sections 1341(a)(4) and Section 1341(a)(5) of the Internal Revenue Code of 1954; see *Hugoton Production Co.* v. *United States*, 349 F.2d 418 (Ct. Cl. 1965). In fact, if the petitioner's theory were correct then the tax adjustment called for here would require that, after the Revenue Service made its adjustment, the Federal Power Commission would have to reopen the rate cases to adjust the rates which are formulated by reference to the economics of the industry and which includes depletion but not the tax effect thereof.

It should be noted that in the *Permian Basin Area Rate Cases*, Nos. 90, et al., Oct. 1967 Term, decided May 1, 1968, this Court pointed out (p. 71, footnote 115) that in determining the average rate for basin producers an allowance

for income taxes was *not* included, the Federal Power Commission noting that the producers will incur no Federal income tax liability at any return up to 15 percent. (The Commission determined a rate of 12 percent.) The effect of the "tax equalization" adjustment proposed by petitioner would necessitate reconsideration in rate cases of the very subject matter that the Federal Power Commission refused to consider because of its difficulty and varying impact upon individual producers.

In fact, the Internal Revenue Service itself has been reluctant to attempt the adjustment proposed by petitioner. (See Technical Advice Memorandum From Natural Resources Division to District Director, St. Louis, Mo., Appendix A, pp. 1a-3a.) Acceptance of the *petitioner's* argument would not result in certainty but could only result in uncertainty in the application of the revenue laws. That is why the Court of Appeals rejected the petitioner's contentions.

The Court below did not hold that a producer who makes a refund is entitled to deductions of $1.275 for every dollar refunded. It merely held that the tax effect of business transactions cannot be held open indefinitely so as to determine their long-range economic results and that an otherwise allowable current year business expense cannot be made to depend on the original source of the funds used to pay it.

Respondent does not quarrel with the proposition that the deduction referred to in Section 1341(a)(4) must be defined by other Code provisions and the long series of precedents supporting that definition. It merely reiterates that no Code provision or judicial precedent permits what petitioner proposes to do. The only case which even gives a scintilla of support to petitioner's contention, *O'Meara* v. *Commissioner*, 8 T.C. 634 (1948), is inconsistent on its face, was not reviewed by an appellate court, and the issue involved, being one of several, was obviously not clearly

presented to the Tax Court. There, too, the real issue was whether the taxpayer was entitled to *any deduction at all.* No ordinary and necessary business expense was involved. Without the transactional approach no deduction would have been permitted. In any event, the theory applied there is precisely the theory applied in *Perry* v. *United States, supra,* which the Court of Claims, in *A. P. Sullivan Corp.* v. *United States, supra,* lately held, at petitioner's urging, was erroneously decided.

Further, in the interim after *O'Meara* Congress enacted Section 1341 of the Code and in doing so made the clear distinction between a recomputation of prior year's *taxes* and the current year's *deduction* taken by respondent, Skelly Oil Company, in the instant case. Application of the alleged *O'Meara* rule, as defined by petitioner, would nullify that distinction.

The "paucity of litigation" on the subject is clearly not because all taxpayers acceded to petitioner's contention. More likely it is either because the Revenue Service has never before pressed such a theory (see Appendix A, pp. 1-3) or the theory is just not applicable to all taxpayers because of the necessity of determining individual facts and circumstances in order to apply it.

Because of the many legal and factual problems that must still be analyzed and determined before any validity can be ascribed to petitioner's novel theory of "tax equalization" (see, e.g., *Hugoton Production Co.* v. *United States, supra*) it is submitted that this issue is not ripe for review by this Court and no purpose would be served by further review of this case.

Conclusion

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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Appendix A

Jan 12, 1968

District Director
St. Louis District Office

Chief, Engineering and Valuation Branch
National Office T:I:E:N:2

[Taxpayer's name and address omitted]

AU:F:227

Years: 1959, 1962-1965

This is in reply to a memorandum dated November 9, 1967, requesting technical advice as to the proper Federal income tax treatment of refunds on the sale of natural gas ordered by the Federal Power Commission (F.P.C.) and the allocation thereof to transmission, overhead and other related charges.

The pertinent facts as presented in your memorandum, a memorandum to Mr. Richard Moore, Technical Coordinator, St. Louis, dated November 6, 1967, and a letter from the taxpayer dated November 3, 1967, are understood to be as follows:

[Taxpayer's name and address omitted.]

[Taxpayer] is principally engaged in the production, long distance transmission and sale of natural gas. Such gas is transported largely in interstate commerce, and is sold along its route to some 100 local natural gas distribution companies for the purpose of resale, and also to various industries for their own use. [Taxpayer's] natural gas transmission system consists of four parallel lines and extends a distance of approximately 1,200 miles in and from the Hugoton Embayment in the states of Texas, Oklahoma, and Kansas, through the states of Missouri, Illinois, Indiana, and Ohio, into the state of Michigan. [Taxpayer] produces approximately 15 to 20 per cent of the natural gas transported and sold through its system.

Under the Natural Gas Act, (15 U.S.C. 717 *et seq*), the F.P.C. has regulatory jurisdiction over [taxpayer] as an interstate natural gas pipeline company. In general, the F.P.C. regulates the prices [taxpayer] can pay for purchased gas and the prices at which it can sell gas to customers for resale. The major part of [taxpayer's] sales are to customers for resale and are subject to F.P.C. regulatory jurisdiction. The F.P.C. also promulgates accounting rules, performs compliance audits, and generally oversees the accounting and reporting practices of the natural gas companies under its jurisdiction.

Of the gas that [taxpayer] produces, the portion that is sold at the wellhead does not go into the [taxpayer] system and is not the subject of this technical advice request. The remaining portion of the gas that [taxpayer] produces is not sold on the lease but enters the [taxpayer] transmission pipeline system, along with purchased gas, and is transported to the various markets. This latter described gas is the subject of this technical advice.

The taxpayer's depletion computation on this latter gas was based on some unstated figure which, upon audit, was "adjusted by the Internal Revenue Service to reflect depletion upon the royalty price used by [taxpayer] in making payment to its royalty owners." See November 6, 1967 letter referred to above.

It is understood that the F.P.C. in ordering the refunds, did not allocate the amount to be refunded to the cost of produced gas, or to transportation costs, or to overhead costs, etc.

The questions on which you have requested technical advice may be stated as follows:

1. "Under the facts in this case the refunds as ordered by the F.P.C. are not broken down into any parts, i.e., no portion of the sales price is allocated to the cost of produced gas, transportation costs,

overhead costs, etc. Should these total sums refunded be allocated to any of the above mentioned items?"

2. "If the value of any of the above refunds *should* ultimately be allocated to gas sales, at the wellhead, should this amount be reduced by the depletion previously taken?" [Emphasis in original text.]

Based upon the foregoing, the price of the gas at the wellhead for depletion purposes, was determined by the District Director, without regard to any sale at the wellhead (which was absent in this case) or without regard to any sale at the end of the transmission line. Furthermore, the refund directed to be made by [taxpayer], because of overcharges to its customers, was determined without regard to any wellhead price of the gas. Therefore, no portion of the sales price refund should be allocated to the cost of producing gas, transportation costs, overhead costs, etc.

In as much as it has been determined that, *under the facts of this case,* that no portion of the gas sales refund should be allocated as set out above, the total of such refund should *not* be reduced by depletion previously taken. However, in those instances wherein refunds are allocated to gas sales at the wellhead, then the amount of refund must be reduced by the depletion previously taken. [Emphasis supplied by Respondent.]

— — End — —

In the Supreme Court of the United States

OCTOBER TERM, 1968

No. 280

UNITED STATES OF AMERICA, PETITIONER

v.

SKELLY OIL COMPANY

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

1. The respondent's brief diverts attention from the basic question here. The issue is not whether the Court should resurrect the "transactional" approach to revenue accounting, an approach that has been repeatedly rejected. On the contrary, this case arises solely because it is clear that the "transactional" approach is not accepted in federal tax law, and that annualized concepts of income tax accounting have been required. In annual accounting, however, the events of an earlier year must often be considered in order to determine the proper treatment of what occurs afterwards. That is the essence of the issue raised here.

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Respondent's basic contention in defense of the decision below is an argument that the court of appeals majority did not accept: that the amounts refunded in 1958 are deductible as ordinary business expenses rather than as a loss. Of course, cases such as *Healy* v. *Commissioner,* 345 U.S. 278, 284, indicate that what happened was a loss, and is deductible only as a loss.

The cases respondent relies on, *Kornhauser* v. *United States,* 276 U.S. 145; *Welch* v. *Helvering,* 290 U.S. 111; and *Commissioner* v. *Tellier,* 383 U.S. 687, are not inconsistent with this conclusion. *Kornhauser* and *Tellier,* as well as the pertinent dictum in *Welch* (290 U.S. at 114), are addressed to the question whether the expenses of defending certain lawsuits are deductible business expenses; the fact that they are has no bearing on the tax consequences of the refund of part of the purchase price paid by respondent's customers. The latter amounts, when paid to respondent, represented part of its "gross income from the property", which formed the basis for the percentage depletion that respondent claimed. The refund of those amounts necessarily means that respondent's gross income from mining has been adjusted downwards. Thus these payments are not analogous to such items as salaries—or the attorneys' fees ~~petitioner~~ respondent paid in defending against its customers' suits—that are deducted in the computation of net income, and would not be appropriately considered in determining what is gross income from the property for purposes of computing the depletion deduction.

2. Contrary to ~~petitioner~~ respondent's repeated suggestions (Br. 13, 15–16, 22), *Alice Phelan Sullivan Corp.* v. *United States*, 381 F. 2d 399 (Ct. Cl.), supports rather than refutes the government's position here. The problem in *Sullivan* involved the return to a taxpayer of property that had previously been given, in two parts, to a religious organization and had been the subject of two charitable deductions. Although the parties agreed that the return of the property should result in an addition to income for the later year, in the amount of the deductions earlier claimed and allowed, the taxpayer contended that its tax could be increased by no more than the amount by which its tax was reduced by reason of the earlier charitable deductions. The Court of Claims disagreed, and sustained the government's contention that the current year's tax rate was applicable to the full amount previously deducted.

In *Sullivan*, there was no question of depletion, and it could not be said there that the taxpayer was claiming a double deduction. However, the underlying rationale in *Sullivan* bears importantly on this case. The Court of Claims rested (381 F. 2d at 401) on a "principle * * * well engrained in our tax law that the return or recovery of property that was once the subject of an income tax deduction must be treated as income in the year of its recovery". Here the general problem is much the same, except that the receipt of money rather than its disposition was the subject of a percentage deduction in an earlier year. Because that receipt represented part of respondent's gross income

from the property, which gave rise to the depletion deduction, the repayments should result in the restoration of 27½% of that gross income allowed when received.

3. There is no foundation for respondent's assertions (Br. 11–12, 16–17, 20–22) that the issue here is *sui generis* and the decision below is not applicable to any other taxpayer. This case is by no means the last that will be heard of the problem. For example, petitioner errs in its assertion (Br. 20–21) that the question will not arise with respect to the natural gas producers involved in the *Permian Basin Area Rate Cases*, 390 U.S. 747. Even assuming *arguendo* that the rates set there will result in no federal income tax liability[1] on the natural gas production operations of a given taxpayer, it does not follow that the producer could not make use of a double deduction such as the court below has allowed respondent. When the natural gas there being regulated was produced and sold, depletion would surely have been claimed, either because taxable income was realized on the gas sold in those years, or because the gas revenues would be combined with oil revenues from the

[1] It is not clear that those producers would have no tax liabilities. The essential point of this Court's opinion is that the producers had failed to provide the necessary evidentiary support for a tax allowance; one possible inference of the contentions made in this Court is that some taxes were being paid. See 390 U.S. at 824 & n. 115. Cf. *Cities Service Gas Co.*, 30 F.P.C. 158, 163. Statistics available to the Internal Revenue Service indicate that oil and gas producers have an effective tax rate of about 7 to 9% of gross receipts, after depletion, but before any foreign tax credits that may be available. These data were part of the record before the FPC. See 3 Joint Appendix, cited in the *Permian* case, n. 115, *supra*, at p. 992.

property for purposes of computing depletion. Even if there is no taxable income from gas production as such in the later years when the refunds are made, the deduction allowed here, which is a loss deduction and not a depletion deduction, could be taken against income from other sources, or carried back against earnings of earlier years, or forward to later years.[2]

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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OCTOBER 1968.

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[2] Private tax rulings such as the one appended to respondent's brief cannot be relied upon by any party except the taxpayer to whom they are issued. *E.g.*, *Weller* v. *Commissioner*, 270 F. 2d 294 (C.A. 3); see, also, *Helvering* v. *New York Trust Co.*, 292 U.S. 455, 468. We point out, however, that the ruling deals with the problem of apportioning certain expenses between mining and nonmining activities for purposes of computing gross income from mining. Cf. *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76. The only part that relates to the issue in this case is the last sentence, which takes the same position as we do here: "in those instances wherein refunds are allocated to gas sales at the wellhead, then the amount of refund [deducted] must be reduced by the depletion previously taken."

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In the Supreme Court of the United States

OCTOBER TERM, 1968

No. 280

UNITED STATES OF AMERICA, PETITIONER

v.

SKELLY OIL COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The findings of fact, conclusions of law and decision of the district court (R. 20–30) are reported at 255 F. Supp. 228. The initial opinion of the court of appeals (R. 37–44) and the majority (R. 47–48) and dissenting (R. 49–54) opinions on rehearing are reported at 392 F. 2d 128.

JURISDICTION

The initial judgment of the court of appeals was entered on April 20, 1967 (R. 45). The United States' petition for rehearing was granted on June 26, 1967. (R. 33, 46). The judgment on rehearing was entered on April 3, 1968 (R. 55). On July 2, 1968, Mr. Justice

Brennan entered an order extending the time for filing a petition for a writ of certiorari to and including July 9, 1968. The petition was filed on July 9, 1968, and was granted on October 14, 1968 (R. 56). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether respondent, a producer of natural gas, in computing its taxable income for 1958, was entitled, as the court below held, to deduct the full amount of overcharges ($505,536) it refunded to customers in that year, or whether the deduction should be reduced, as the government contends, by 27½ percent or $139,022, representing depletion claimed and allowed as a deduction in computing taxable income in the prior years when respondent had included the $505,536 in its gross income.

STATUTE AND REGULATION INVOLVED

Sections 611(a), 613(a), 613(b)(1), and 1341(a) of the Internal Revenue Code of 1954, and pertinent parts of Section 1.1341–1 of the Treasury Regulations on Income Tax (1954 Code) appear in the Appendix, *infra*, pp. 31–34.

STATEMENT

Respondent produces natural gas in Oklahoma. By order effective August 1, 1952, the Oklahoma Corporation Commission established a mandatory minimum price for sales of natural gas. In 1958, this Court ruled that the Oklahoma Commission was without jurisdiction. *Michigan Wisconsin Pipeline Co.* v. *Cor-*

poration Commission of Oklahoma, 355 U.S. 425. On remand, the Oklahoma Supreme Court vacated the minimum price order. In 1958, respondent paid $500,000 in settlement of a lawsuit one of its customers, Cities Service Company, brought against it, and it paid $5,536 to another of its customers, Dorchester Corporation, to compensate the latter for amounts it had been required to pay in a suit brought by a party to whom it had resold respondent's gas. These amounts represented excess amounts collected under the invalid minimum price order. (R. 13–17, 21–25, 38).

Respondent had included the $505,536 in its gross income as received during the taxable years 1952 through 1957, since it then claimed an unrestricted right to them. In determining its taxable income for each of those prior years, respondent had claimed and the Commissioner of Internal Revenue had allowed percentage depletion with respect to such amounts, at the rate of 27½ percent. The depletion deductions totalled $139,022. (R. 23–25, 38–39).

In its federal income tax return for 1958 respondent claimed the entire $505,536 as a deduction. In auditing the return, the Internal Revenue Service reduced otherwise allowable percentage depletion for such taxable year by $139,022, representing 27½ percent of $505,536. This resulted in an additional assessment of tax for the year 1958, which respondent paid together with interest. Thereafter respondent filed a timely claim for refund. This claim was not allowed, and the

instant suit for refund was timely commenced. (R. 12–13, 19, 25–26, 38–39).[1]

The district court sustained the government's position (R. 29–30). The court of appeals, however, reversed, holding that Section 1341 of the Internal Revenue Code of 1954 entitled respondent to deduct the full $505,536 (R. 37–44). After granting a rehearing (R. 46), two members of the court of appeals panel adhered to the original decision, and one judge dissented (R. 47–54).

The United States filed a petition for certiorari, which was granted on October 14, 1968 (R. 56).

SUMMARY OF ARGUMENT

Every Internal Revenue Law since the adoption of the Sixteenth Amendment has required that income be returned and tax paid on an annual basis. The so-called "claim of right" doctrine is a corollary of the annual accounting system. It was developed to deal with the situation where a taxpayer in one taxable year receives money thinking it is his, but in a later period repays part or all of the amount. In such a case, the taxpayer is required to return the amount as part of his gross income in the year of receipt, and is allowed a deduction upon repayment. Until the adoption of Section 1341 of the Internal Revenue Code of 1954, that deduction could be claimed only in the year of repayment. Because this rule caused hardship for

[1] The deficiency notice and refund proceedings raised other issues with respect to respondent's 1958 tax liability. These questions were resolved by stipulation in the trial court and are not in issue here. See R. 19, 26, 31.

some taxpayers (who might, for example, be taxable in a lower bracket in the year of repayment), section 1341 was inserted in the Code.

Under section 1341, income which a taxpayer receives or accrues under a claim of right is included in gross income in the year of receipt or accrual, as under prior law. With respect to the allowable deduction, however, the taxpayer is given an alternative. It may, under section 1341(a)(4), claim the deduction in the year of repayment, as under prior law; or it may, under section 1341(a)(5), compute its tax for the year of repayment without the deduction, and then reduce the tax so computed by the amount of tax attributable to the inclusion of the repaid amount in the income of the earlier years. Respondent here relies on section 1341(a)(4).

Section 1341 applies if three conditions are met. These are: (1) "an item was included in gross income for a prior taxable year (or years)" under a claim of right; (2) "a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item"; and (3) the "deduction exceeds $3,000." The problem of statutory construction here is in the meaning of the word "deduction", for section 1341(a)(4) states that if the above three conditions are met, then the taxpayer computes its tax "with such deduction" for the year of repayment.

The purpose of the statute shows that the "deduction" referred to must be determined by other parts of the tax law. The error of the court of appeals re-

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sults from its confusion of the word "item" referred to in section 1341(a)(1) with the word "deduction" used in the succeeding three subsections. But nothing in section 1341 purports to define the "deduction" to which it refers. Section 1341 only states the consequences that follow if other provisions of the tax law allow a "deduction" as a result of the taxpayer being required to repay amounts previously received under claim of right.

The pertinent provision here is section 165(a) of the Internal Revenue Code of 1954, which provides for the deduction of losses. Under other provisions of the Code, however, the amount deducted cannot exceed the taxpayer's adjusted basis in the item that is the subject of the loss. Under accepted principles of tax accounting, respondent's adjusted basis is the amount previously included in gross income, less the depletion deduction previously claimed with respect to those amounts. This is illustrated by *Arrowsmith* v. *Commissioner*, 344 U.S. 6, where a taxpayer who had reported as capital gain amounts received upon liquidation of his corporation was required to treat his later payments to corporate creditors, as transferee of the corporate assets, as a capital loss, since they arose out of and were a consequence of the prior capital transaction.

The result below is also inconsistent with a long line of decisions which hold that taxpayers may not claim more than one deduction of the same amount. Respondent was first allowed a deduction of 27½ percent, as its depletion allowance, when it included

the receipts in income for the years 1952 through 1957. Yet, after part of those same receipts were repaid to its customers, respondent has been allowed to deduct 100 percent of the repayments, thus overlapping the prior depletion allowance. Every time a comparable situation has come to this Court, the result has been that the double deduction has been denied.

In the alternative, this case may be analyzed by allowing respondent a full deduction for the amounts repaid to its customers in 1958, but requiring it to add to its gross income for that year an amount equal to the depletion allowed in the years 1952 through 1957 with respect to the amounts repaid in 1958. Such an analysis would be consistent with the general principle that requires a restoration to income of amounts previously claimed as a tax deduction where they are later recovered by the taxpayer, or a change in circumstances shows that the deduction should not have been claimed. This, for example, occurs where a charity returns property to a donor, who previously had taken a charitable deduction with respect to his gift, or where a business accrues wages, which later go unclaimed. This Court, in *Rothensies* v. *Electric Storage Battery Co.*, 329 U.S. 296, 298, expressly stated its agreement with this rule. Moreover, in *Douglas* v. *Commissioner*, 322 U.S. 275, this Court reached a comparable result in sustaining a Treasury Regulation that requires percentage depletion taken on advance royalties on a mining lease to be restored to income if the lease is later terminated without production having occurred.

ARGUMENT

This case presents essentially a question of proper tax accounting.

The problem may be approached (1) through the construction of a particular statutory provision, Section 1341 of the Internal Revenue Code of 1954. Or (2) it may be approached as essentially an accounting problem; *i.e.*, what is the proper treatment in terms of tax accounting where a repayment is made in a later year of an item received in an earlier year, where depletion was deducted with respect to the item in the earlier year in which it was received.[2]

Both considerations lead to the same result, and both support and reinforce each other. They are intertwined in the argument which follows.

BOTH SECTION 1341 OF THE INTERNAL REVENUE CODE OF 1954 AND ACCEPTED PRINCIPLES OF TAX ACCOUNTING REQUIRE THAT RESPONDENT'S DEDUCTION BE IN THE AMOUNT OF THE SUMS REFUNDED TO CUSTOMERS LESS THE CORRESPONDING DEPLETION DEDUCTIONS PREVIOUSLY CLAIMED AND ALLOWED WITH RESPECT TO THOSE SUMS

A. RESPONDENT'S DEDUCTION IS TO BE DETERMINED BY THE PRINCIPLES THAT GENERALLY GOVERN THE ALLOWANCE OF DEDUCTIONS AND IS NOT DEFINED BY SECTION 1341 OF THE INTERNAL REVENUE CODE OF 1954

The practicalities of taxation require that accounts be rendered and taxes paid on a fixed periodic basis. "Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practicable

[2] No problem of "tax benefit" arises, since a full tax benefit was received when the depletion deduction was taken, and the tax rates were essentially the same in the several years involved.

operation." *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, 365. Thus, the federal income tax laws have, since the Sixteenth Amendment, been based on the annual accounting period. The present case presents an example of the need—which the Congress, the courts, and the Treasury have all recognized—to make appropriate adjustments for distortions that sometimes arise where the transactions of one taxable year are the product of what has gone before.

Analysis of the present problem must begin with the "claim of right" doctrine, which has been developed to deal with the situation where, as here, a taxpayer receives or accrues an amount in one year, thinking it is his, but in a later tax period is required to restore or repay some or all of it. In *North American Oil* v. *Burnet*, 286 U.S. 417, 424, the Court held that a taxpayer who received money "under a claim of right and without restriction as to its disposition * * * has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent." This Court went on to say that if a taxpayer is later required to refund some part of the money, it is (*ibid.*) "entitled to a deduction from the profits of [the year when the refund is made] * * *, not from those of any earlier year." *United States* v. *Lewis*, 340 U.S. 590, and *Healy* v. *Commissioner* 345 U.S. 278, expressly held that the deduction may be claimed only for the year of repayment.

This remained the unqualified rule until the enactment of the Internal Revenue Code of 1954. Congress then added section 1341 to the Code because "[i]n

many instances of this nature the deduction allowable in the later year does not compensate the taxpayer adequately for the tax paid in the earlier year." [3] The operative provisions are in section 1341(a).[4] They provide as follows:

> If—
>
> (1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;
>
> (2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and
>
> (3) the amount of such deduction exceeds $3,000,
>
> then the tax imposed by this chapter for the taxable year shall be the lesser of the following:
>
> (4) the tax for the taxable year computed with such deduction; or

[3] S. Rep. No. 1622, 83d Cong., 2d Sess., p. 118; H. Rep. No. 1337, 83d Cong., 2d Sess., p. 86.

[4] Section 1341(b)(2) provides that section (a) "does not apply to any deduction allowable with respect to an item which was included in gross income by reason of the sale or other disposition" of an item held for sale to customers in the regular course of business. There is an exception, however, for "refunds or repayments with respect to rates made by a regulated public utility * * *" that are required by a governmental body, a court order, or in settlement of litigation. Respondent's payments to Cities Service and Dorchester plainly fall within the exception to section 1341(b)(2) so that section 1341(a) does apply to this case. (See R. 15, 17.)

(5) an amount equal to—

(A) the tax for the taxable year computed without such deduction, minus

(B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).

The scheme of the statute is readily apparent. The first three paragraphs state conditions that must be met if the statute is to be applied. The fourth and fifth paragraphs provide alternative rules for determining the tax consequences of restoration of an amount received under a claim of right in a prior taxable period, and set the taxpayer's liability at "the lesser" of the tax computed under each alternative. The first option, stated in section 1341(a)(4), allows a deduction in the year of repayment, as did earlier law. The second, which is in section 1341(a)(5), is the new rule whose adoption was the purpose of section 1341. Under this, if a smaller tax is produced, the taxpayer may reduce his tax for the year of repayment by the amount of tax which was paid on the receipt in the prior year.

In the present case the adjustment for the prior year under section 1341(a)(5) would clearly be in the amount of the tax resulting from the *inclusion* in income of the amount received *and* the *deduction*

of 27½ percent of that amount as percentage depletion—that is, the tax on 72½ percent of the amount received, which is the amount of tax respondent paid when it included the amounts in income in 1952 through 1957. Respondent, however, relies on the other alternative provided by the statute, section 1341(a)(4). This is, in all essence, the same as that which was available before the statute was passed.

The question then turns on the proper construction of section 1341(a). The key to this in the present context, we submit, is found in the fact that Congress used one word in section 1341(a)(1) and a different word in section 1341(a)(2), and in sections 1341(a)(4) and (5).

In section 1341(a)(1) the operative reference is to an "item" which was included in gross income for the previous year. In this case, the item which was included in gross income in the previous year was the amount which was received for the sale of gas. If the word "item" had been used in sections 1341(a)(2), (4), and (5), it might be difficult to contend that the amount of the deduction which those provisions allow is different from the amount specified in section 1341(a)(1). However, this is not what Congress wrote. In section 1341(a)(2), Congress provided that if "a deduction" is allowable—that is, a "deduction," whatever its proper amount may be, and not necessarily the same amount as the "item" referred to in section 1341(a)(1)—then the tax should be determined under section 1341(a)(4) by determining "the tax for the taxable year computed with *such deduction*" (emphasis supplied).

Thus, the section does not allow the deduction of the "item" to which section 1341(a)(1) applies, but does provide for the computation of tax using the "deduction"—whatever is the appropriate amount of the deduction, under all the circumstances—under sections 1341 (a) (2) and (4). Section 1341(a) is not itself a deduction provision. It merely provides that whatever deduction is allowable under other provisions of the statute shall be taken into account in carrying out the adjustment which section 1341 authorizes. Thus section 1341(a) sheds no light on the amount of the deduction, but we must look to other provisions of the statute, and to relevant decisions, in determining the answer.

The result reached below depends entirely on the conclusion of the majority of the court of appeals that the word "deduction" necessarily encompasses the full amounts that respondent repaid to its customers in 1958 (R. 41). But nothing in Section 1341 specifies the amount of the "deduction", or qualifies or enlarges that amount in any way. As the legislative materials emphasize, section 1341(a)(4) is only intended to codify the rule of *Lewis* and *Healy*. See S. Rep. No. 1622, *supra*, pp. 118, 451; H. Rep. No. 1337, *supra*, pp. 86–87, A294–A295. It is those cases and the other provisions that allow deductions in computing taxable income which must provide the point of reference for determining the "deduction" to which section 1341(a)(4) refers.

This conclusion is supported by the pertinent Treasury Regulations. Section 1.1341–1(a)(1) of the In-

come Tax Regulations (Appendix, *infra*, p. 32) provides that: "If, during the taxable year, the taxpayer *is entitled under other provisions of chapter 1* * * * to a deduction * * *," he may claim one of the options provided in section 1341 (emphasis supplied). It is also confirmed by the fact that section 1341 appears not in Subchapter B, where the deductions allowed in computing taxable income are set forth, but rather in Subchapter Q, which contains a variety of provisions best described by the subchapter title: "Readjustment of tax between years and special limitations." Indeed, the court of appeals majority opinion here expressly recognizes (R. 42) that in section 1341(a)(4) "Congress * * * enacted the existing rule as to current year deductions * * *." Accord *National Life and Accident Ins. Co.* v. *United States*, 244 F. Supp. 135 (M.D. Tenn.), affirmed on other issues, 385 F. 2d 832 (C.A. 6).

This makes it necessary to determine what deduction would be allowable if section 1341 had not been enacted, a question that the court of appeals majority failed to analyze adequately. The pertinent principles provide two distinct approaches, each, however, yielding the same result. First, the issue may be analyzed simply as a problem of determining a loss deduction. It is clear under the established principles of tax accounting that such a deduction is limited to 72½ percent of the amounts respondent repaid to its customers in 1958. Or, second, the transaction might be analyzed by allowing a deduction for the full amount repaid, but requiring the restoration of the previously allowed percentage depletion to income in

the year of repayment, since gross income must include amounts for which a tax benefit has been claimed if events of a later year negative the basis for the earlier claim of a deduction. Compare *Douglas* v. *Commissioner*, 322 U.S. 275. We shall devote the remainder of this brief to a discussion of these alternatives.

B. SECTION 165 OF THE INTERNAL REVENUE CODE OF 1954 REQUIRES THAT RESPONDENT'S LOSS DEDUCTION BE LIMITED TO 72½ PERCENT OF THE AMOUNTS REFUNDED TO CUSTOMERS IN 1958

We begin with the elementary proposition that a taxpayer has the burden of bringing its claim of a deduction within some specific statutory provision, *e.g.*, *United States* v. *Olympic Radio and Television*, 349 U.S. 232, 235; *New Colonial Co.* v. *Helvering*, 292 U.S. 435, 440; *Deputy* v. *du Pont*, 308 U.S. 488, 493, and that those provisions are to be closely construed, *e.g.*, *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260, 265.

As *Healy* v. *Commissioner*, *supra*, 345 U.S. at 284 and n. 17, holds, the relevant provision here is that for the deduction of a loss, now Section 165(a) of the Internal Revenue Code of 1954. See G.C.M. 16730, XV–1 Cum. Bull. 179 (1936). Respondent may have its deduction only as allowed by this statutory provision. Although many of the provisions of section 165 relate to losses of capital assets, its rules provide the proper analogy for analysis of the present problem. The essential provision is section 165(b), which limits the loss that may be deducted to the taxpayer's adjusted basis in the item that is the subject of the loss. In this case the loss is not capital in na-

ture, but represents repayments of amounts received in the ordinary course of business.

Thus, the computation of the amount of deductible loss begins with the fact that the full amounts of respondent's 1958 refunds to customers were, in prior years, included in gross income.[8] That is not, however, the whole picture. After including these amounts as gross income, respondent claimed and was allowed a depletion deduction amounting to 27½ percent of the gross amount. In the case of losses of property the Internal Revenue Code, in provisions now found in section 1016(a)(2), requires that an appropriate adjustment in basis be made for deductions previously taken for a variety of purposes, including "depletion". Since respondent's depletion was measured by its prior gross receipts from its gas producing property, these gross receipts should be reduced by the previously claimed depletion in order to measure respondent's loss which section 165 allows it to deduct.

[8] Several courts of appeals have held that a "basis" exists for such an item only if the receipts have been reported in income for tax purposes. See, *e.g.*, *Johnson* v. *Commissioner*, 162 F. 2d 844 (C.A. 5); *Commissioner* v. *Timken*, 141 F. 2d 625, 627–628 (C.A. 6); *Crane* v. *Commissioner*, 68 F. 2d 640 (C.A. 1); *Doneghy* v. *Alexander*, 118 F. 2d 521 (C.A. 10); *Rains* v. *Commissioner*, 33 B.T.A. 1189; see, generally, 5 Mertens, *Law of Federal Income Taxation* (1964 ed. and cum. supp.) § 28.12. The Second Circuit, however, in *Bennet* v. *Helvering*, 137 F. 2d 537 (C.A. 2), held that there is a basis even if the taxpayer should have reported an item as income but innocently failed to do so. See, also, *Alsop* v. *Commissioner*, 290 F. 2d 726. Since respondent included its receipts in gross income in 1952 through 1957, the courts of appeals would agree that in this case the initial basis is the amounts received in these years.

This analysis, which was followed in the only other case that has considered the application of the "claim of right" rule to a depletion problem such as this case presents, *O'Meara* v. *Commissioner*, 8 T.C. 622, 632–635, is confirmed by *Arrowsmith* v. *Commissioner*, 344 U.S. 6. There this Court held that when a repayment is made, the tax consequences of the repayment depend upon the facts surrounding the original receipt. In that case, the taxpayers received sums in liquidation of a corporation, which were then taxable as a capital gain. Several years later the taxpayers were required to pay certain obligations of the corporation, because of their status as transferees of the corporate assets. Though in the later year there was clearly no "sale or exchange," which is the usual earmark of a capital gain or loss, the Court held that these repayments were deductible only as a capital loss, since they arose out of and were a consequence of the prior capital transactions.

Arrowsmith illustrates the principle that the deduction in the year of repayment is not to be viewed in isolation without regard to all the steps in the transaction involved, and it also demonstrates that the deduction must be consistent with the tax treatment of the income in the prior years. Thus, if the taxpayers in *Arrowsmith* had been allowed an ordinary loss, as contended by them, they would have received an ordinary deduction for 100 percent of an amount which had been taken into income for prior years on the special basis applicable to capital gains.

The repayment in this case was of an amount previously received from the production of natural gas; it

was included in "the gross income from the property" which section 613(a) makes the basis for the percentage depletion allowed upon the production of natural gas. The result was that in the years 1952 through 1957 respondent had taken into taxable income only 72½ percent of the amounts received in those years. When these amounts were refunded in 1958, the loss deduction then should take into account these antecedent facts, as *Arrowsmith* illustrates. An unqualified 100 percent deduction such as respondent seeks here was not permitted in *Arrowsmith,* and for like reasons it is not permissible here.

C. THE RULE FORBIDDING DOUBLE DEDUCTIONS REQUIRES THAT RESPONDENT'S DEDUCTION BE LIMITED TO 72½ PERCENT OF THE AMOUNTS REPAID TO CUSTOMERS IN 1958.

In a large group of cases the courts have held that a taxpayer may not take more than one deduction with respect to the same money payment. *Ilfeld Co.* v. *Hernandez,* 292 U.S. 62, is particularly relevant. In that case, a parent corporation, for a number of years filed consolidated tax returns with two subsidiaries. Over the years, the subsidiaries' losses exceeded their profits, and those losses, through use of the consolidated returns, were used to diminish the parent's taxable profits. Then the subsidiaries' assets were sold, their debts paid, and the balance paid to the parent in cancellation of its stock. The parent sought to claim a loss deduction in the amount by which its basis in the stock exceeded the funds distributed on liquidation. Pointing to the fact that the subsidiaries' losses, which had been claimed as deductions on the consolidated

tax returns, had caused the diminution of assets that resulted in the parent's loss when the subsidiaries were liquidated, this Court rejected the parent's claim to a loss deduction upon liquidation. It said (292 U.S. at 68):

> If allowed, this would be the practical equivalent of double deduction. In the absence of a provision of the Act definitely requiring it, a purpose so opposed to precedent and equality of treatment of taxpayers will not be attributed to lawmakers. Cf. *Burnet* v. *Aluminum Goods Co.*, 287 U.S. 544, 551. *United States* v. *Ludey*, 274 U.S. 295, 301. There is nothing in the Act that purports to authorize double deduction of losses or in the regulations to suggest that the commissioner construed any of its provisions to empower him to prescribe a regulation that would permit consolidated returns to be made on the basis now claimed by petitioner.

United States v. *Ludey*, 274 U.S. 295, on which *Ilfeld* relies, is also pertinent here. The question in that case was the basis to be used for computing the taxpayer's gain upon the sale of real property with respect to which depletion had previously been claimed and allowed. The transaction took place before the adoption in 1924 of the first predecessor[4] of section 1016(a)(2), so that there was then no express statutory provision requiring that basis be reduced in the amount of depletion claimed and allowed. This Court nevertheless unanimously held that the basis must be so reduced, saying that (274 U.S. at 301) "[a]ny

[4] See section 202(b) of the Revenue Act of 1924, 43 Stat. 253, 255.

other construction would permit a double deduction * * *." This rule has long been incorporated in the Treasury Regulations. Thus, Section 1.1016-6(a) of the Regulations under the 1954 Code requires that "[a]djustments [to basis] must always be made to eliminate double deductions or their equivalent." See, also, Regulations 86 under the Revenue Act of 1934, Article 113(b)-1, at p. 198.

This policy against double deduction is expressly written into part of section 1341, with which the present case is most directly concerned. Section 1341(b)(3), added to section 1341 in 1958, 72 Stat. 1647, provides:

> If the tax imposed by this chapter for the taxable year is the amount determined under subsection (a)(5), the deduction referred to in subsection (a)(2) shall not be taken into account for any purpose of this subtitle other than this section.

Thus Congress emphasized that a taxpayer who chose to make use of the new procedure allowed by section 1341(a)(5) could not also lay claim to the equivalent of a double deduction by invoking the rule of *Healy* and *Lewis*, which are codified in section 1341(a)(4).

A similar policy is expressed in the committee reports on section 1341, in yet another context. Various deductions—for example those for charitable contributions—are limited to a percent of gross income. A taxpayer who returns as gross income an amount received under a claim of right thereby increases the limit on the amount of such deductions that he may claim. The problem arises if he claims the maximum of such a

deduction for a taxable year, and later restores or repays an amount received under a claim of right and included in gross income for that year. If he then takes the option provided in section 1341(a)(5), he may receive an excessive deduction for such items—unless he also is required to adjust his earlier charitable and similar deductions. Both the House Ways and Means Committee and the Senate Finance Committee had this to say about such a prospect (H. Rept. No. 1337, *supra,* at p. A294; S. Rept. No. 1622, *supra,* at p. 452):

> In computing the tax reduction for the prior taxable year attributable to the removal of the item in question, if the earlier year would otherwise be closed, no other items may be adjusted. However, to the extent that adjusted gross income or taxable income may be changed, items such as the medical and charitable deductions which are dependent upon income may also be affected.

This view has been expressly incorporated in the Treasury's Regulations on Income Tax, Section 1.1341–1(d)(4) (Appendix, *infra,* pp. 33–34).

In these materials, the Congress and the Treasury have dealt with the more obvious procedures by which the taxpayer might seek a double deduction through invoking section 1341. No one had foreseen the need to comment on or specifically provide for the present situation. But as the above quoted portions of the Committee reports imply, Congress expected that established, general principles would forestall any attempt to claim (292 U.S. at 68) "the practical equivalent of double deduction" through reliance on section 1341(a)(4).

Section 1341 must be construed in a sensible manner, and not, as the court of appeals has here, as opening up a wholly unintended and unnecessary loophole in the statute by reading its language "so broadly * * * as to defeat rather than further the purpose of Congress"—which, as this Court has said, cannot be justified. *Corn Products Co.* v. *Commissioner,* 350 U.S. 46, 52; *Burnet* v. *Harmel,* 287 U.S. 103, 108. Notwithstanding the clear, overriding principle that double deductions are not to be allowed, and the expression of a legislative intent to apply to section 1341 the principle that forbids double deductions, the court below and respondent would impute to Congress an intention not only to compensate the taxpayer adequately for the tax paid in the prior years, which is clearly the purpose of section 1341 in general and section 1341(a)(5) in particular, but also an intention to go far beyond such compensation and grant to it by section 1341(a)(4) what amounts to a double deduction for depletion.

This is precisely the effect of the decision below. First respondent claimed and was allowed the 27½ percent depletion deduction when its customers' payments were received. Now the court of appeals has allowed respondent to deduct the full amount of the repayment in 1958, including the entire amount previously claimed and allowed as depletion. In this Court's words in *Ilfeld,* it has allowed "the practical equivalent of double deduction," for the effect of the court of appeals decision is to allow a natural gas producer which makes such a refund to claim total tax deductions of $1.275 for every dollar refunded to customers. In terms of tax liability, respondent pays less than it

would have if it had never included the receipts in its income; having originally paid some $190,000 in taxes with respect to the overcharges, it has been granted a refund of $263,000 in a later year, even though tax rates and all other relevant principles of law remained the same throughout the period. Any producer in the same situation may achieve a comparable tax windfall. This exceptional result, which Congress plainly did not intend, and which finds no warrant in the language of section 1341 or any other provision of the revenue laws, can be avoided only if respondent's deduction is limited to that amount which will avoid a double deduction, and that is 72½ percent of the 1958 repayments.

D. IN THE ALTERNATIVE, IF RESPONDENT IS ENTITLED TO A DEDUCTION IN THE FULL AMOUNT OF ITS REPAYMENTS TO ITS CUSTOMERS, IT MUST INCLUDE IN ITS GROSS INCOME AN AMOUNT EQUAL TO THE DEPLETION PREVIOUSLY CLAIMED AND ALLOWED WITH RESPECT TO THE AMOUNTS REFUNDED

The problem of this case may be analyzed in a somewhat different manner, which reaches essentially the same result. Thus, respondent's repayment might be treated by allowing a deduction for the full amount repaid, but requiring the restoration of the percentage depletion to income in the year of repayment. Though the earlier depletion deduction was correct when made, the eventual repayment established the fact that no percentage depletion deduction was in fact allowable. There was, to this extent, no eventual receipt from the production of gas, and under proper principles of tax accounting, the amount of percentage depletion previously deducted should be restored to income.

This analysis rests on the "principle * * * well engrained in our tax law that the return or recovery of property that was once the subject of an income tax deduction must be treated as income in the year of its recovery." *Alice Phelan Sullivan Corp.* v. *United States,* 381 F. 2d 399, 401 (Ct. Cl.). This principle finds expression in a variety of cases dealing with circumstances where a taxpayer in one year obtains a refund of an amount that it had earlier paid out and claimed as a deduction in computing its federal income tax liability for a prior year, or where, in some manner, circumstances that come to pass in one year show the impropriety of a deduction that was claimed and allowed in an earlier year, and which had seemed proper on the basis of the facts as they then existed. In these circumstances, the courts of appeals and the Court of Claims have ruled that the gross income of the later years must be increased in the amount of the deduction previously claimed.

One case deals with the return to a taxpayer of property that was previously given to a charity and made the subject of a charitable deduction. *Alice Phelan Sullivan Corp.* v. *United States, supra.* Others deal with the refund of excise or other taxes that have previously been deducted as a business expense. *E.g., Freihofer Baking Co.* v. *Commissioner,* 151 F. 2d 383, 386 (C.A. 3); see also *Union Trust Co. of Indianapolis* v. *Commissioner,* 111 F. 2d 60 (C.A. 7), certiorari denied, 311 U.S. 658. Another group of cases reach a like result where an accrual has been made, and deducted, for wages, and the wages then go unclaimed. *Chicago, R.I. & P. Railway Co.* v. *Commis-*

sioner, 47 F. 2d 990 (C.A. 7), certiorari denied, 284 U.S. 618; *Charleston and Western Carolina Railway Co.* v. *Burnet*, 50 F. 2d 342 (C.A. D.C.). Similarly, when an amount previously deducted as a reserve for bad debts is found to be excessive in a later year, the excess amount must be included in income in that year. *Arcadia Savings and Loan Assn.* v. *Commissioner*, 300 F. 2d 247 (C.A. 9). Similarly, even before any statute so provided, where an insurance company's previously deducted reserves were excessive, and they were, accordingly, reduced, the amount of the reduction becomes taxable income. See *Maryland Casualty Co.* v. *United States*, 251 U.S. 342, 351–353; L.O. 1032, 2 Cum. Bull. 216; see also *Massachusetts Protective Association* v. *United States*, 114 F. 2d 304, 312–313 (C.A. 1); *Sneed* v. *Commissioner*, 119 F. 2d 767, 771 (C.A. 5).

The result is always the same. The prior deduction must be restored to income, at least where a tax benefit was received from the deductions, as was the case here. This Court expressly stated its agreement with this view in *Rothensies* v. *Electric Storage Battery Co.*, 329 U.S. 296, 298; cf. *Security Flour Mills Co.* v. *Commissioner*, 321 U.S. 281.

The application of the rule to the present case is illustrated by the Court of Claims' recent decision in *Alice Phelan Sullivan Corp.* v. *United States, supra.* The problem in *Sullivan* involved the return to a taxpayer of property that had previously been given, in two parts, to a religious organization and each part had been the subject of a charitable deduction. Although the parties agreed that the return of the property should result in an addition to income for

the later year, in the amount of the deductions earlier claimed and allowed, the taxpayer contended that its tax could be increased by no more than the amount by which its tax was reduced by reason of the earlier charitable deductions. The Court of Claims disagreed, and, relying on such cases as *Rothensies* v. *Electric Storage Battery Co., supra,* sustained the government's contention that the current year's tax rate was applicable to the full amount previously deducted.[7]

Here the general problem is much the same, except that the receipt of money rather than its disposition was the occasion for a deduction in an earlier year. Because that receipt represented part of respondent's gross income from the property, which gave rise to the depletion deduction, the repayments should result in the restoration to gross income of the depletion deduction of 27½ percent of the amount which was allowed when respondent first received the moneys under claim of right.

The present situation is also similar to the one in *Douglas* v. *Commissioner,* 322 U.S. 275, where the taxpayers were the lessors of an iron ore mine, and the lessee guaranteed them minimum royalties. The lessee paid the minimum royalties each year but removed no ore at all, and at the end of eight years, the lease was cancelled. The taxpayers took depletion deductions in the years when the royalties were paid. A Treasury Regulation[8] required restoration of the deductions to

[7] In so doing, the court overruled its prior decision in *Perry* v. *United States*, 142 Ct. Cls. 7, 160 F. Supp. 270.

[8] Article 23(m)-10(c) of Treasury Regulations 94, issued pursuant to Section 23(m) of the Revenue Act of 1936, c. 690, 49

income in the year of termination of the lease, since there had been no production and the ore in taxpayer's mine remained unimpaired. The taxpayers contended that the regulation was invalid, but this Court upheld and enforced it.[9]

The right to depletion rests on extraction of a mineral and the amount of the allowance under section 613 is a percentage of the "gross income" resulting from the extraction. Just as the depletion is restored to income when, as in *Douglas*, attempts at extraction are abandoned in a year after the income has been received and reported, see *e.g.*, *Freeman* v. *Commissioner*, 48 T.C. 96, respondent should be required to make an adjustment for depletion taken in prior years since it later developed that part of the gross income—that which formed the basis of the depletion claimed—had to be refunded.

At the time our petition for certiorari was filed here, there was no Treasury Regulation bearing directly on the problem, as there was in *Douglas*. Since that time, the Treasury has published, in 33 Federal Register 10700, July 26, 1968, a comprehensive set of proposed regulations designed to provide uniform rules with respect to a variety of depletion problems. One of those proposals deals specifically with the problem of this case. It provides as follows:

Stat. 1648. It is now section 1.612–3(b)(2) of the Treasury Regulations on Income Tax under the 1954 Code.

[9] On one aspect of the *Douglas* case, relating to "tax benefit," the Court was equally divided. 322 U.S. at 287. But on the basic issue, relating to the restoration to income of the previously deducted depletion. The vote was six to two in favor of the propriety of the restoration.

SEC. 1.613–2 *Percentage depletion rates.*

* * * * *

(c) *Rules for application of paragraph (a) of this section.* * * *

* * * * *

(8) If the taxpayer restores or repays amounts included in gross income from the property for a prior year as part of the actual or constructive selling price of ores or minerals, then the amount of any deduction otherwise allowable on account of such restoration or repayment shall be decreased to the extent that a deduction for percentage depletion with respect to the amounts previously included in income, but subsequently restored or repaid, reduced taxable income in such prior year or years (either directly or indirectly as, for example, as part of a net operating loss deduction). See § 1.611–0. If appropriate, a corresponding adjustment shall be made to capital account. Examples of instances in which this subparagraph shall apply are payments made as a result of a court decision, the settlement of a claim, or a voluntary repayment.

This proposed regulation provides in effect that the deduction otherwise allowable under section 1341 (a)(4) shall be reduced by the percentage depletion allowed in previous years, if the depletion reduced taxable income in the previous years.

The proposed regulation is essentially clarifying in nature, and is intended as an analogue to the regulation sustained in *Douglas*. The Treasury, sustained as we have shown by long established rules of tax accounting, would use its authority to provide by regula-

tion for the computation of depletion (section 611(a)) "according to the peculiar conditions in each case" so as to forbid the result reached in the court of appeals. We, of course, cannot rest on this proposal, and if it is adopted as a regulation, its validity may well turn on the outcome of the instant case. It serves, however, to emphasize, through the expression of the administrative agency to whom Congress has granted particularly broad authority to define and delimit the depletion deduction, the validity of our contentions here. In the circumstances of this case, no less than in *Douglas,* the authorities provide an ample basis for denying the windfall that respondent claims, the grant of which would be inconsistent with the function and purpose of the depletion allowance.

CONCLUSION

The judgment below should be reversed, and the judgment of the district court reinstated.

Respectfully submitted.

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APPENDIX

Internal Revenue Code of 1954:

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) *General Rule.*—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate.

* * * * *

(26 U.S.C. 611.)

SEC. 613. PERCENTAGE DEPLETION.

(a) *General Rule.*—In the case of the mines, wells and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

(b) *Percentage Depletion Rates.*—The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

(1) 27½ percent—oil and gas wells.

* * * * *

(26 U.S.C. 613.)

SEC. 1341. COMPUTATION OF TAX WHERE TAXPAYER RESTORES SUBSTANTIAL AMOUNT HELD UNDER CLAIM OF RIGHT.

(a) *General Rule.*—If—

(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;

(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

(3) the amout of such deduction exceeds $3,000,

then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

(4) the tax for the taxable year computed with such deduction; or

(5) an amount equal to—

(A) the tax for the taxable year computed without such deduction, minus

(B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).

* * * * *

Treasury Regulations on Income Tax (1954 Code):

§ 1.1341–1 *Restoration of amounts received or accrued under claim of right.*—(a) *In general.*—

(1) If, during the taxable year, the taxpayer is entitled under other provisions of chapter 1 of the Internal Revenue Code of 1954 to a deduction of more than $3,000 because of the res-

toration to another of an item which was included in the taxpayer's gross income for a prior taxable year (or years) under a claim of right, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year shall be the tax provided in paragraph (b) of this section.

(2) For the purpose of this section "income included under a claim of right" means an item included in gross income because it appeared from all the facts available in the year of inclusion that the taxpayer had an unrestricted right to such item, and "restoration to another" means a restoration resulting because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item (or portion thereof).

* * * * *

(b) *Determination of tax.*—(1) Under the circumstances described in paragraph (a) of this section, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year shall be the lesser of—

(i) The tax for the taxable year computed under section 1341(a)(4), that is, with the deduction taken into account, or

(ii) The tax for the taxable year computed under section 1341(a)(5), that is, without taking such deduction into account, minus the decrease in tax * * * for the prior taxable year (or years) which would result solely from the exclusion from gross income of all or that portion of the income included under a claim of right to which the deduction is attributable. * * *

(d) *Determination of decrease in tax for prior taxable years.*—* * *

* * * * *

(4) *Computation of amount of decrease in tax.*

* * * * *

(ii) No item other than the exclusion of the income previously included under a claim of right shall be considered in computing the amount of decrease in tax if reconsideration of such other item is prevented by the operation of any provision of the internal revenue laws or any other rule of law. However, if the amounts of other items in the return are dependent upon the amount of adjusted gross income, taxable income, or net income (such as charitable contributions, foreign tax credit, deductions for depletion, and net operating loss), appropriate adjustment shall be made as part of the computation of the decrease in tax. For the purpose of determining the decrease in tax for the prior taxable year (or years) which would result from the exclusion from gross income of the item included under a claim of right, the exclusion of such item shall be given effect not only in the prior taxable year in which it was included in gross income but in all other prior taxable years * * * affected by the inclusion of the item (for example, prior taxable years affected by a net operating loss carryback or carryover or capital loss carryover).

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No. 280

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1968.

UNITED STATES OF AMERICA,
Petitioner,

v.

SKELLY OIL COMPANY.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR SKELLY OIL COMPANY

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BRIEF FOR SKELLY OIL COMPANY

Opinions Below

The findings of fact, conclusions of law and decision of the district court (R. 20-30) are reported at 255 F. Supp. 228. The initial opinion of the court of appeals (R. 37-44) and the majority (R. 47-48) and dissenting (R. 49-54) opinions on rehearing are reported at 392 F.2d 128.

Jurisdiction

The initial judgment of the court of appeals was entered on April 20, 1967 (R. 45). The United States' petition for rehearing was granted on June 26, 1967 (R. 33, 46). The judgment on rehearing was entered on April 3, 1968 (R. 55). On July 2, 1968, an order was entered extending the time for filing a petition for a writ of certiorari to and including July 9, 1968. The petition was

filed on July 9, 1968, and was granted on October 14, 1968 (R. 56). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1). Respondent's brief on the merits is due to be filed on December 29, 1968.

Question Presented

Where respondent, a producer of natural gas, produced and sold the mineral during the years 1952 through 1957, and the sale price thereof entered into the computation of its depletion allowance, and in 1958, pursuant to a lawsuit, it was required to repay a portion of said sales price, does Section 1341(a)(4) of the Internal Revenue Code of 1954 require that its otherwise allowable ordinary and necessary business expense deduction or its otherwise allowable current year depletion deduction be adjusted so as to reflect the previously allowed depletion deduction?

Statute and Regulations Involved

Sections 162, 1341(a), and 1341(b) of the Internal Revenue Code of 1954 and the pertinent parts of Section 1.1341-1 of the Treasury Regulations on Income Tax (1954 Code) appear in the *Appendix*, infra, pp. 33-34.

Statement

Respondent, Skelly Oil Company, produces and sells natural gas in Oklahoma and was so engaged in 1952 when the Oklahoma Corporation Commission established a minimum price for sales of natural gas at the wellhead (R. 13-15, 21). This order raised the price of the gas respondent was selling under pre-existing contracts with Cities Service Company and Dorchester Corporation (R. 14, 22). The minimum price order was ruled invalid in *Michigan Wisconsin Pipeline Co. v. Corporation Commission of Oklahoma*, 355 U.S. 425 (1958), and was subsequently vacated (R. 14-15, 22).

In computing its depletion allowance for each of the years 1952 through 1957, Skelly had included in its "gross income" and in its "gross income from the property" the amounts charged under the invalidated minimum price order (R. 16, 17, 18, 23-25).

In 1958, Cities Service Company sued Skelly for $777,853.25, representing alleged overcharges for natural gas purchased by it from Skelly between August 1, 1952 and December 22, 1957. Also in 1958, Dorchester Corporation, which sold gas to Northern Natural Gas Pipeline Company of America for Skelly's account, was required, due to the invalidation, to repay Natural Gas Pipeline Company for alleged overcharges and it sought reimbursement from Skelly (R. 15, 17, 24-25).

In October and November, 1958, Skelly paid $5,536.54 to Dorchester Corporation and settled the lawsuit brought by Cities Service Company by paying Cities $500,000 (R. 15, 17, 23, 25). On its Federal tax return for 1958 Skelly took a business expense deduction for the $505,536.54 which it had paid to Dorchester and Cities Service (R. 18-19, 25-26).

Upon audit of Skelly's Federal tax return for 1958 the Internal Revenue Service reduced Skelly's otherwise allowable depletion allowance on its mineral production *for 1958* by $139,022.55, representing 27½ percent of the $505,536.54 deducted on the return. Skelly paid the resulting assessment and filed a claim and later a suit for refund (R. 25-26).

The only issue presented to the trial Court was whether, in computing Skelly's liability for Federal income tax for the taxable year ending December 31, 1958 under the provisions of Section 1341(a)(4) of the 1954 Internal Revenue Code, it was proper to reduce its otherwise allowable percentage depletion for the taxable year by $139,022.55 representing 27½ percent of $505,536.54, the purchase price received by it from the sale of natural gas

during prior taxable years, which purchase price had been included by it in gross income for such prior taxable years under a claim of right without restriction as to use, and which it was required to restore to the payors thereof during the taxable year ending December 31, 1958; or, in the alternative, whether Skelly was required to reduce its otherwise allowable deduction under Section 1341(a)(4) of $505,536.54 by 27½ percent, or $139,022.55, to reflect percentage depletion previously claimed and allowed thereon in its Federal income tax returns for the years in which such amount was taken into gross income under a claim of right without restriction as to use (R. 11, 12, 20-21).

The trial Court held that Skelly was entitled to a deduction in 1958 of only $366,513.99 on account of the $505,536.54 payment (R. 29-30), but the Court of Appeals unanimously reversed holding that no legal authority supported the decision (R. 37-44). After granting a rehearing, the Court of Appeals reiterated its prior decision with one judge dissenting (R. 47-54).

The United States filed a petition for certiorari on July 9, 1968, which was granted on October 14, 1968 (R. 56).

Summary of Argument

Prior to the enactment of the Internal Revenue Code of 1954 the "claim of right doctrine," based upon the concept of annual accounting for income tax purposes, was firmly established in the tax law. Under that doctrine if a taxpayer received income under claim of right, reported it in gross income in one year and in a later year was obliged to repay it or its equivalent, a deduction for the repayment could only be taken in the year of repayment. The application of the doctrine sometimes resulted in a burden and sometimes resulted in a benefit to the taxpayer.

In enacting Section 1341 of the Internal Revenue Code of 1954, Congress proposed to mitigate partially the stringent application of the "claim of right" treatment by establishing two alternatives, either of which would mandatorily apply depending upon which yielded the greater benefit to the taxpayer. Under the first alternative a *deduction* could be taken in the year of repayment for the amount repaid; under the second the *tax* for the year of receipt could be recomputed solely by excluding the amount repaid from the gross income of the year of original receipt.

Section 1341 applies if (1) an item was included in "gross income" for a prior taxable year or years under claim of right; (2) a deduction is allowable for the current taxable year because it was established after the close of the prior year or years that the taxpayer did not have an unrestricted right to such item; (3) the deduction exceeds $3,000; and (4) the deduction does not involve an item which was included in gross income by reason of the sale or disposition of stock in trade or property held primarily for sale to customers in the ordinary course of business, *unless* the deduction arises out of refunds or repayments with respect to rates made by a regulated public utility if such refunds or repayments are required by a Governmental agency or by an order of a Court, or are made in settlement of litigation or under threat or imminence of litigation.

In the instant case the respondent met all the requirements for the application of Section 1341 and since no greater benefit was derived under either alternative, respondent was required to take the deduction in the year of repayment pursuant to subsection 1341(a)(4). The amount was included in "gross income" in the prior years, was restored in settlement of litigation and the amount involved exceeds $3,000. Although the natural gas was held for sale in the course of business, refunds on account of such sales were specifically included by Congress within the coverage of the Section.

The amount restored in 1958 was properly deducted on the return for said year as an ordinary and necessary business expense and not as a loss from one transaction. The transactional approach to the claim of right situation was rejected by this Court in *Healy* v. *Commissioner*, 345 U.S. 278 (1953), and by the Congress when Section 1341 was enacted. No "double deduction" is involved herein because the depletion deduction allowed or allowable in prior years was proper in said years, was a mandatory deduction, and was measured by "gross income from the property" and not "gross income." Although the depletion deductions to which respondent was entitled in prior years was determined by reference to the *gross income from the property*, the full amount later restored was included in *gross income* in the years of receipt—all that is required by the statute. The depletion deduction was allowed in prior years because the mineral was depleted; the deduction in the year here involved was occasioned by the payment of $505,536 as an ordinary and necessary business expense. Here, two separate and distinct events took place—the depletion of mineral and the payment of money. The cases which prohibit "double deductions" all involved two deductions for the same item. Where a deduction in the year of repayment is involved, Section 1341(a)(4) does not permit the prior year or years to be reconsidered or the *tax* for said years to be redetermined.

It is neither possible nor proper to create income in the taxable year of repayment by adding to gross income in the year of restoration an amount equal to the total depletion deduction taken in the prior several years when an amount equivalent to the amount restored was included in gross income. Such a procedure would call for the creation of an "inverse" tax benefit rule which is not and cannot be recognized under the law. The tax benefit rule itself does not apply because no benefit was bestowed upon respondent in the taxable year. To the contrary it *paid out* money. It recovered nothing.

Argument

A. Under the law in effect prior to the enactment of Section 1341 of the Internal Revenue Code of 1954, the judgment below is correct.

The most fundamental concept of tax law, and the essence of our system of taxation, is that income and deductions must be determined on an annual basis. The doctrine was established by this Court in *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359 (1931), and further elaborated upon and strengthened in *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417 (1932), *United States* v. *Lewis*, 340 U.S. 590 (1951), and *Healy* v. *Commissioner*, *supra*. Most recently, this concept was reaffirmed in *Commissioner* v. *Gordon*, 391 U.S. 83 (1968).

The annual accounting approach was established in *Burnet* v. *Sanford & Brooks Co.*, *supra*, because of its ease of application and its production of revenue at regular intervals. In doing so this Court specifically rejected the "transactional" approach or method which would postpone the assessment of the tax, until the transaction giving rise to income or deduction is finally concluded, to the end of a lifetime or for some other indefinite period.

In *North American Oil Consolidated* v. *Burnet*, *supra*, it was established that if a taxpayer receives income under claim of right he must report it as income even though it subsequently develops that its equivalent must be restored. *United States* v. *Lewis*, *supra*, established that in such circumstances, the taxpayer, if he was entitled to any deduction, was limited to a deduction of the amount restored only in the year of restoration. *Healy* v. *Commissioner*, *supra*, made it clear that the deduction must be the amount restored and is not to be limited to the *tax* paid when the restored item was originally received. It was recognized that the application of the rule could

result in either a benefit or a burden to the taxpayer or to the Government.

The issue before the Court is not really one of statutory construction or proper tax accounting as the petitioner contends. The statute is clearly written and the tax accounting rules have long been established. Respondent has contended, and the Court below has held, that the taxpayer here has applied the statute as Congress specifically intended it to be applied and has complied precisely with the rules of tax accounting long established by statute, regulation and judicial precedent. The real issue in the case is whether the Government may refuse to apply the statute and the accounting rules to this taxpayer because *it* believes that, in this particular year and with regard to this particular taxpayer, a windfall has been received. Regardless of the eventual economic outcome, and regardless of the long-term effect on other taxpayers or the Revenue Code itself, the petitioner proposes the adoption by this Court of a new "inverse tax benefit" rule which Congress itself refused to adopt. It is not enough to say that the tax rates in the years here referenced were essentially the same. Congress did not intend that subsection 1341(a)(4) would apply only when there had been a change in tax rates. If it had so intended, Congress would have said so.

In the present application of the revenue laws to adjustments between years rarely does either the Government or the taxpayer come out even at any given moment. Petitioner, however, would have this Court amend the law so that only taxpayers are penalized.

B. Section 1341 of the Internal Revenue Code of 1954 and its legislative history completely sustain the judgment of the Court below.

In enacting Section 1341 of the Code, it is clear that Congress was concerned only with partially adjusting the application of the so-called "claim of right doctrine" and was concerned only with the impact of the doctrine in one particular year. It was not concerned with the net economic aspects involving the receipt or payment of money over an extended period of time. In making such adjustment Congress had two choices: it could repudiate the annual accounting concept and adopt an "open transaction" doctrine under which a taxpayer would annually recompute and reevaluate its taxes on the basis of current developments as they affected all prior years and thus redetermine the net *tax* effect on a protracted or "open account" basis; or, it could provide a method of making a partial adjustment within the framework of existing law. It chose the latter by establishing two alternative but limited choices where a taxpayer received and reported income under claim of right and, due to later developments, was required to restore it.

Under the first alternative, a taxpayer could take a deduction in the year of restoration or repayment without reference to prior inclusion or exclusion. Section 1341(a)(4). Under the second alternative, he could compute the reduction in tax for the year of receipt which would result from the exclusion of the item from gross income. Section 1341(a)(5). The applicable alternative is to be determined by one test: which one yields the *greater tax benefit* to the taxpayer.

The intent of the statute is that a taxpayer may continue to determine his annual taxes within the context of the long-established "claim of right doctrine" by taking a *deduction* or, if the amount involved is large (exceeds $3,000) *and* the greater benefit is thereby obtained, the reduction in

tax for the prior year occasioned by excluding the amount received becomes the measure of the reduction of *tax* in the current taxable year. The only conditions established by the statute are that the amount exceed $3,000 and the amount restored has once been included in "gross income," a term of art in the tax law. Treasury Regulations Section 1.61-3(a). See, Revenue Ruling 60-344, 1960-2 Cum. Bull. 186. The taxpayer here complied with all of the conditions of the section and took the deduction as prescribed therein. Taxpayer was benefited thereby as Congress fully intended. See Congressional Committee Reports, Appendix, pp. 34-39.

Although the law is clear and unequivocal, the petitioner has sought to deny its application in this case, not by attacking the statute itself but by a scatter-shot attack on the equity of its application to this particular taxpayer in this particular instance by proposing an argument based on what it divines to have been the intention of Congress. To do this, however, it finds it necessary to not only distort Section 1341 but also to misconstrue other fundamental principles of tax law.

Contrary to the petitioner's assertion, Congress has never attempted to adjust *all* distortions occasioned by annual accounting principles and substitute an "open account" concept which would remove *all* inequities in the Revenue Code and equalize taxes paid from year to year as circumstances changed. Instead Congress has provided for *partial* amelioration of some of the most prevalent distortions and let the less common ones remain in the law regardless of whether the benefit or burden falls on the Government or the taxpayer. For an example of a circumstance where a taxpayer is burdened, see *Alice Phelan Sullivan Corp.* v. *United States*, 381 F. 2d 399 (Ct. Cls. 1967).

By the same token it is less than candid for the petitioner to attempt to justify its contention by blurring and softening the "claim of right doctrine" so as to imply that

it applies only when the original transaction is conditional. Until now it has always been the position of the Government that the doctrine applies only where a taxpayer receives income which is unequivocally his when received but *later developments* arising out of the circumstances of the original receipt require its restoration. The Government has repeatedly recognized this distinction and has used it to defeat the application of Section 1341 of the Code (which provides only a *partial* alternative to "claim of right"), by insisting that the Section only applies where some *subsequent* development occurs which deprives the taxpayer of an amount *equivalent* to that which he once included in gross income because it was then *absolutely* his. See Revenue Ruling 62-14, 1962-1 Cum. Bull. 11.

Neither are the petitioner's contentions supported by its argument based upon some mysterious and pseudo-sophisticated distinction between the terms "item" and "deduction" as used in the statute. The thrust of the argument is that the term "item" was intended by Congress to have a different meaning than the terms "amount" and "deduction."

The invalidity of this argument is illustrated by the petitioner's own statement on page 12 of its brief:

> "In section 1341(a)(1) the operative reference is to an 'item' which was included in gross income for the previous year. In this case, the *item* which was included in gross income in the previous year was the *amount* which was received for the sale of gas. If the word 'item' had been used in sections 1341-(a)(2), (4), and (5) it might be difficult to contend that the *amount* of the deduction which those provisions allow is different from the *amount* specified in section 1341(a)(1)." (Emphasis supplied.)

Respondent submits that the word "item" *is* included in Section 1341(a)(2)! That subsection ties together the words "amount" and "item" as follows:

"(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right *to such item* or to a portion of *such item*, * * *." (Emphasis supplied.)

The term "such item" can only refer to the *amount* included in gross income. Subsections (4) and (5) have no need to refer again to the "item" because they merely provide for the manner of handling the *deduction for the item* as described in subsections (1) and (2). The Revenue Service itself has always used and applied the terms "item" and "amount" interchangeably in this context. See, Revenue Ruling 58-226, 1958-1 Cum. Bull. 318.

It should be noted here that the petitioner, at p. 12 of its brief, where it purports to partially quote subsection 1341(a)(2), interpolates its own language into the quotation so as to avoid quoting the term "item" from the subsection. Respondent submits that the statute is as Congress wrote it—not as re-written by the petitioner. This substitution of paraphrasing language designed to create the impression that the statutory provision does *not* contain words which are, in fact, there, casts a shadow on the validity of petitioner's contentions in this case.

Regardless of this distortion of the statute, however, reference to the Congressional Committee Reports clearly shows that Congress intended to, and did, use the terms "amount" and "item" interchangeably in Section 1341. See House Report No. 1337, 83d Congress, 2d Session (1954), pp. 86, 87, A294, A295; Senate Report No. 1622, 83d Congress, 2d Session (1954), pp. 118, 451, 452. (Appendix, *infra*, pp. 34-39.)

Of course, the purpose of this distorted version of the law as presented by petitioner is clear. It is an attempt to engraft upon the statute and into the case law the "transactional approach" that Congress repudiated and this Court, in the past, has unfailingly rejected. Without this approach, however, the petitioner has no case.

Arrowsmith v. *Commissioner*, 344 U.S. 6 (1952), is inapposite here because only a transactional loss was involved in that case. There the taxpayer had in a prior year reported the gain from the liquidation of a corporation (one transaction) as a capital gain. In a subsequent year he was required to repay some of the amounts received and claimed an ordinary loss deductible in full. This Court held that the taxpayer was not in the trade or business of liquidating corporations and, hence, any loss deductible must be deducted as a capital loss. Otherwise the repayment would not have been deductible at all! The same distinction applies to the case of *O'Meara* v. *Commissioner*, 8 T.C. 622 (1948), where the taxpayer was required to take a loss deduction because it was finally determined that he had no title to the producing property itself.

Taxpayer here does not produce mineral on a transactional basis or as a "one-shot" proposition. It is in the trade or business of producing oil and gas for sale to customers in the ordinary course of business. No *loss* during the taxable year is involved. The Treasury Regulations under Section 165 specifically exclude from the purview of that section losses on account of inventory or stock in trade. Treasury Regulations Section 1.165-2. See, also, Treasury Regulations Section 1.471-2.

Respondent sustained a business expense by *paying out* $505,536. The payment did *not* occur because the mineral was not in fact depleted in prior years, but because taxpayer was required to pay out money in settlement of a law suit. The issue is obfuscated by the petitioner's insistence upon lumping together and equating the production of mineral and the depletion allowance on the basis of dollar amounts as if the business operations consisted of the production of dollars and not of mineral. This approach overlooks or ignores the fact that the depletion allowance is merely *measured* by dollars because that is the method prescribed by Congress.

The inapplicability of this new Government theory can be demonstrated by one question. If a producer of mineral receives no depletion deduction in a taxable year because of the taxable income limitations provided by Section 613 (a) of the Code, would the Government allow an additional depletion allowance in subsequent years when that limitation was greatly exceeded? In justice it should if its "open account" theory is correct and acceptable. We all know, however, that it will not because the depletion allowance is limited to 27½% of gross income from the property produced and sold in the *current taxable year*.

The fallacy of allowing the Government to interrupt in one year the orderly scheme of the revenue collecting process under the rules devised by Congress and the courts is illustrated clearly by reference to the adjustment proposed in this case. Here the Revenue Service adjusted downward the depletion deduction attributable to the current year's production, and to which the taxpayer admittedly was otherwise entitled, because of depletion properly taken in prior years. Taxpayer thus is deprived, in 1958, of the full depletion allowance to which it is otherwise entitled on account of its current production. Will the Government recognize this deprivation in a subsequent year if a taxable income limitation arises? In that event the Government would correctly maintain that the depletion deduction must be determined on an annual basis and without reference to financial aspects or occurrences in prior or subsequent years. So too, the taxpayer here correctly maintains that the Government may not ignore the annual accounting rules.

The core of the problem, insofar as this controversy is concerned, is that Section 1341 was never intended to operate in the manner which petitioner seeks to apply it. Hence petitioner must warp other sections of the Revenue Code in an attempt to obscure the clear purpose of Con-

gress. Ordinarily it would not attempt such a perilous adventure but it deems the "loophole" large enough to justify the attack. Admittedly Congress intended a benefit but the petitioner says, in effect, not this much. The real problem, however, is that the gas sold by respondent was held for sale to customers in the regular course of business. See Revenue Ruling 68-620, Internal Revenue Bulletin 1968-49, p. 6. In Section 1341(b)(2) Congress excluded sales of inventory or property held for sale to customers from the application of the section but deliberately and specifically included within its coverage refunds from such gas sales which, such as in the instant case, were required by a governmental body, a court order or in settlement of litigation, (Petitioner's Brief, p. 10, footnote 4.) See, Treasury Regulations Section 1.1341-1(f)(2). If it were not for this specific inclusive provision the section would not apply and the refunds here involved would be treated like any other inventory adjustment. It can hardly be presumed that Congress *unintentionally* legislated a benefit in this situation when it specifically provided for the inclusion of the payments here involved within the purview of the statute. The Senate Committee Report specifically states that refunds of charges for the sale of natural gas would be eligible for the benefits of this section. See, Senate Report No. 1622, 83d Congress, 2d Session (Appendix, pp. 36-39). In the circumstances it is obvious that Congress knew precisely what it was doing. If it had intended the adjustment sought by the petitioner it could have easily said so.

Inherent in the petitioner's argument is the proposition that subsection 1341(a)(4) is a legislative nullity and the supposedly "alternative" Section 1341(a)(5) is the only subsection to be applied in all cases. Respondent submits that Congress intended that Section 1341 be applied as written and that a taxpayer must select the one of two alternatives that produces the *lesser* tax. The section was

not designed to equalize the *tax!* If equalization were intended it could easily have been accomplished by legislating *only* subsection 1341(a)(5) and not enacting subsection 1341(a)(4). Instead, Congress enacted both subsections 1341(a)(4) and 1341(a)(5) and the petitioner is really asking this Court to rule subsection 1341(a)(4) *invalid* because, in petitioner's opinion, it allows a greater benefit than it would like to believe Congress intended.

C. The "Transactional Loss" argument proposed by petitioner avoids the issue in the case.

In its brief, pp. 14, *et seq.*, the petitioner states the issue as being confined to one of two distinct approaches; first, as a problem of determining the amount of a "loss" or, second, whether the previously allowed depletion deduction must be restored to income because of the prior tax benefit when events of a later year negative the basis for the earlier claim.

With regard to the "loss" question, the petitioner takes the position that the deduction referred to in Section 1341 of the Revenue Code must be determined under other sections of the Code *and* that Section 165(a), which provides for the deduction of any loss sustained during the taxable year is the applicable one. To quote petitioner's brief (p. 15) the proposition is that "Respondent may have its deduction only as allowed by this statutory provision." Admitting that many of the provisions of Section 165 relate to losses of capital assets, the petitioner proposes that Section 165(b) provides the "proper analogy for analysis of the present problem." Section 165(b), however, merely provides that the amount of a loss deduction shall be the adjusted basis provided in Section 1011 and that section contains no reference at all to a basis for a business expense *deduction*. It merely provides for the determination of the basis of *property* for the sole purpose of determining gain or loss from the *sale or other disposition* of

property. This defect in logic is emphasized in petitioner's brief by the casual observation that "In this case the loss is not capital in nature, but represents repayments of amounts received in the ordinary course of business" (Petitioner's Brief, pp. 15 and 16).

Respondent here has incurred no final loss which would invoke the application of Section 165. The fact is that the deduction involved in this case was taken under Section 162 of the Code which provides for the deduction of expenses incurred in the taxable year in carrying on a trade or business. It was so deducted on respondent's return and the petitioner agreed and stipulated in the Courts below that it was *properly* so deducted. That also happens to be the law. *Kornhauser* v. *United States,* 276 U.S. 145 (1928); *Welch* v. *Helvering,* 290 U.S. 111 (1933); *Commissioner* v. *Tellier,* 383 U.S. 687 (1966). There can be no dispute about that. The "loss" contention did not appear in this case until, in this Court, the petitioner alleged Section 165 to be the only applicable section of the Code, discussed it in its brief by "analogy," and then, in the same breath, conceded its inapplicability.

Thus the petitioner has injected an issue, pulled it back and proceeded to argue its shadow. The very next step is an expedition into the computation of the deductible "loss," which, petitioner admits, begins with the full amounts repaid and which had been previously included in "gross income." (Petitioner's Brief, p. 16.) This is precisely what Section 1341 provides! The section does not require the inclusion in *net* income or *taxable* income—only *gross* income. [At this point respondent respectfully requests the Court to consider carefully the discussion contained in footnote number 5 on page 16 of petitioner's brief. If there is such a thing in tax law as a "basis for a deduction," petitioner has conceded that that basis is obtained by including the amount in *gross income.*] Here respondent included the $505,536 in its *gross income* in the years 1952

through 1957. It paid out $505,536 in 1958 and deducted that amount as an ordinary and necessary business expense like any other business expense such as wages, salaries, operating expenses, etc. That is all that is required by Section 1341 or any other section of the Revenue Code. Although petitioner presents this argument in the name of equity it should be pointed out that under the law, except as provided by definitive statute, neither taxpayers nor the Government have ever been allowed to adjust a current year's tax computation in order to reconsider items *properly* reflected on the return for a different year. Even Section 165, by its terms, refers to losses *sustained during the taxable year.*

It is somewhat anomalous that petitioner can infer all kinds of narrow interpretations of the word "item" used in the Code, but, at the same time, refuse to recognize the long-established meaning of the term "gross income" which has been a term of special meaning in the revenue laws from their inception, and which has been explicitly defined by Treasury Regulations for a half century. See Treasury Regulations 45, Articles 31 to 49, inclusive, under Revenue Act of 1918 (1919).

Petitioner seeks to avoid the explicit terms and clear meaning of Section 1341, and the scope of the case law by using the terms "gross income" and "taxable income" interchangeably. But the distinction has long been inherent in the law. See, 5 Mertens, *Law of Federal Income Taxation* (1964 ed.), Section 28.13. Congress has been well aware of the distinction for many years and has legislated provisions that carefully take that distinction into account, such as the loss-carryover provisions of Section 172 of the Code. If it had intended that the deduction referenced in subsection 1341(a)(4) should be adjusted as petitioner contends, it would have so provided.

Congress was careful to spell out the applicable rules for recomputing *taxable income* when a taxpayer might be required to revert to the prior year for exclusionary purposes under subsection 1341(a)(5). Yet it made no reference to any such adjustments when a current year deduction was in order under subsection 1341(a)(4) of the Code. Presumably Congress meant precisely what it said—taxpayers might utilize whatever subsection provided the *greater benefit.* See Congressional Committee Reports, Appendix, *infra,* pp. 34-39. See also, 2 Mertens, *Law of Federal Income Taxation* (1964 ed.), Section 12.106a. Petititioner admits that the *entire* amount involved was included in "gross income." The cases cited by it clearly establish that that is, and always was, all that was required. The reference to Section 1016(a)(2) of the Code has no bearing on the issue. That section requires an adjustment to the basis of the *producing property* on account of depletion previously allowed when determining *gain or loss* on the *sale or disposition thereof.* No "loss of property" is involved in this case as petitioner implies. Respondent sold natural gas to customers in the usual course of its trade or business. It did not sell the producing property!

Its "basis" in the gas sold was the cost of producing it. When the sales were made they were final and unequivocal and the proceeds were absolutely subject to tax. Just as depreciation must be taken into consideration with regard to the taxable year "allowed or allowable", regardless of whether it was actually taken on the tax return, respondent was required by law to take its depletion deduction in the taxable years when the gas was produced and sold. A subsequent event, *i.e.,* a lawsuit, in a later year obligated respondent to pay back money. But its mineral was gone. There is no provision of the tax law which permits or requires a *reduction* in a taxpayer's basis on account of the

payment of money. Congress has inserted some sections in the Revenue Code which provide for the adjustment of taxes between years but in the absence of such special legislation each taxable year stands on its own. This has always been the law! This was clearly demonstrated by the Government's position in *Alice Phelan Sullivan Corp.* v. *United States, supra.* See also *Hugoton Production Co.* v. *United States,* 349 F.2d 418 (Ct. Cls. 1965).

Congress has just not legislated the adjustment proposed by petitioner. It had ample opportunity to do so but did not. See Committee Reports, Appendix, *infra.* Petitioner is therefore, asking this Court to legislate such an adjustment.

The case of *O'Meara* v. *Commissioner, supra,* so heavily relied upon by petitioner, does not accord with the numerous Courts of Appeal cases cited by petitioner in its brief (page 16, footnote 5). It is contradictory and inconsistent on its face. The Tax Court there recited the rule of law and then proceeded to ignore it. As the many other cases have stressed, and as Section 1341 specifically states, all that is required is that amounts received under claim of right be included in *gross income*—not taxable income, and there is a substantial difference. Any other rule would depend for its application upon whether the particular taxpayer paid a tax. Two taxpayers otherwise similarly situated might be treated differently depending upon extraneous economic factors peculiar to one or the other.

Of the many, many cases decided under the revenue laws since 1913, *O'Meara* is the *only* case ever cited by petitioner in direct support of its position here—and it was not reviewed by a higher court. Further, in that case the taxpayer had lost title to the entire property. In any event, it cannot be presumed that Congress, in enacting subsection 1341(a)(4) with deliberate care and precision (so as to codify *Healy* and *Lewis* as petitioner admits), intended

that *O'Meara* would apply to the exclusion of all other cases, including those decided by this Court. If the Congress so intended it would have surely said so!

In its brief, petitioner itself distinguishes *Arrowsmith* v. *Commissioner, supra,* when it points out that the amounts were repaid as a consequence of a prior *capital* transaction and, hence, only a capital loss was allowed. As previously pointed out, in the instant case no capital transaction is involved. Respondent was, and is still, selling gas in the ordinary course of business and reporting the proceeds of sale as ordinary income.

Petitioner stresses that when viewed from the "transactional" approach, respondent has been allowed a deduction which exceeds the amount originally taxed. That is also true for any taxpayer who is allowed a depletion or depreciation deduction in one taxable year and in a subsequent year uses the same funds or "cash flow" to pay wages, salaries, overhead or other business expenses. Yet the Government has not challenged those deductions! Such "tracing" of dollars has never been permitted in tax law.

The fallacy here is that petitioner is urging an "open account" theory of depletion, the thrust of which is that the depletion deduction may be adjusted from year to year as facts or economics change. Not only is this not permissible but it is prohibited by law. For example, a taxpayer might produce and sell mineral in a given year and receive no percentage depletion deduction if its production costs were high, because of the fifty percent taxable income limitation provided by Section 613(a). If petitioner's theory were correct a taxpayer should be allowed *additional* percentage depletion in a subsequent year when costs were low and the limitation not operative. But this has never been permitted. Compare, *Fribourg Navigation Co., Inc.* v. *Commissioner,* 383 U.S. 272 (1966). It should be noted that even in *Fribourg* the Government did not attempt to adjust depreciation taken in *prior* years. In addition, Section 1.1016-3(a)(1)(ii) of the Treasury Regulations specifically provides that:

> "The determination of the amount properly allowable for exhaustion, wear and tear, obsolescence, amortization, and depletion shall be made on the basis of the facts reasonably known to exist at the end of the taxable year. A taxpayer is not permitted to take advantage in a later year of his prior failure to take any such allowance or his taking an allowance plainly inadequate under the known facts in prior years."

D. No double deduction is involved in this case.

The petitioner in its brief invokes the rule of *Ilfeld Co.* v. *Hernandez,* 292 U.S. 62 (1934), which is alleged to be that a taxpayer may not take "more than one deduction" with respect to the same money payment! No such double deduction is involved here! Respondent has taken only *one* deduction for *one* money payment. It took a depletion deduction when its mineral was depleted because in those taxable years it was required to take the deduction or lose it forever. In 1958 it paid out $505,536 and took a deduction for *that* payment. It took two deductions for two economic deprivations— the depletion of its mineral *and* the payment of money. These events took place in separate and distinct taxable years in the course of respondent's trade or business. The case of *United States* v. *Ludey,* 274 U.S. 295 (1927) does not support the proposition for which it is cited by petitioner. Respondent here has not sold its producing real property. If it had, the principle of *Ludey* might be applicable in determining its gain or loss on that sale, but respondent would still have been obliged to pay out $505,536. (Note that *Ludey* was decided prior to the advent of percentage depletion.) Furthermore, *Ludey* specifically held that the depletion deduction to which a "taxpayer was entitled to deduct" under the tax law in the year of production is inviolate thereafter until *the producing property is sold.* The prior years' tax returns cannot be reopened so as to recompute

the tax impact in those years. *United States* v. *Ludey, supra,* at 303-304. In any event, it must be presumed that if Congress, in enacting Section 1341, had intended to apply petitioner's strained interpretation of *Ludey,* again it would have so provided. Respondent is not claiming a capital gain or loss. It sold nothing in 1958 that mitigated the business expense deduction to which it was entitled in 1958. It was "entitled" under the law to the depletion deductions taken in 1952 through 1957. Those deductions may not be disturbed in a subsequent year unless Congress so provides.

Petitioner devotes a substantial portion of its brief to an argument that an adjustment is required by subsection 1341(a)(5) of the Code. Its brief recites (p. 20) that a "policy against double deductions is expressly written into part of Section 1341, with which the present case is most directly concerned." This statement is followed by a quotation from subsection 1341(b)(3) which refers to the amount determined under "subsection (a)(5)". In this case, however, respondent did *not* recompute its *tax* for 1952 through 1957 under subsection (a)(5) of Section 1341. It took a *deduction* under subsection 1341(a)(4). Subsection 1341(a)(5) is not applicable here! To quote again from petitioner's brief (p. 20):

> "Thus Congress emphasized that a taxpayer who chose to make use of the new procedure allowed by *section 1341(a)(5)* could not also lay claim to the equivalent of a double deduction by invoking the rule of *Healy* and *Lewis,* which are codified in section 1341(a)(4)." (Emphasis supplied.)

This is precisely the point! Respondent has always relied upon the "codification" of the rule of *Healy* and *Lewis* in Section 1341(a)(4). The parties have stipulated, always agreed, and rightly so that subsection 1341(a)(4) is the applicable alternative and the Courts below have decided the issue on that basis. Respondent did not determine its "tax" under subsection (a)(5)! Subsection 1341(a)(5)

is not applicable to this case! Petitioner's quotation from the statute serves to further emphasize the alternatives intended by Congress. Presumably, petitioner admits that the issue has been determined correctly under subsection 1341(a)(4) but is asking this Court to hold that the very specific provisions of subsection 1341(a)(5) must be substituted for subsection 1341(a)(4). Congress refused to so legislate and even the Treasury Regulations under Section 1341 have not attempted to implement such a theory for the very reason that Congress specifically said that this may *not* be done.

The fact is that Congress provided two alternatives: (1) a *deduction* for the *amount* paid out in the year paid under the rule of the *Healy* and *Lewis* cases (subsection 1341(a)(4)), *or* (2) a recomputation of *tax* for the prior years by excluding the *amount* from gross income (subsection 1341(a)(5)), whichever results in the *lesser tax*. This is what the Congress said, deliberately and purposefully. Petitioner argues that Congress could not possibly have meant what it unequivocally said. Respondent submits that petitioner's quarrel is with the Congress not with respondent or the decision of the Court below.

E. Petitioner's alternative argument is not sustainable under The Revenue Code or The Case Law.

The alternative adjustment proposed by petitioner in its brief is that upon payment of the $505,536 in 1958, respondent is required to restore to *income* the depletion deduction taken when the equivalent amount was included in gross income in prior years. There are myriad ramifications to this theory. First of all, however, it should be noted that all of the cases cited by petitioner involve a *return* of property, *refund* of amounts previously paid out, *cancellation* of a debt or obligation that had been previously deducted, and all of which resulted in a recognizable *benefit* to the taxpayer *in that taxable year* either because of the receipt of a benefit or the termination of the

business. These cases then merely recite the long-standing "tax benefit rule." In the instant case, however, there was no benefit conferred on respondent by the refund—it *paid out* money. It experienced an *additional* detriment. It did not terminate its operations—they continue to this day. In fact in *Maryland Casualty Co.* v. *United States*, 251 U.S. 342 (1920), cited by petitioner as support of its theory, this Court, after discussing the theory, held:

> "It would not be difficult to suggest conditions under which the statutory permit to deduct net additions to reserve funds would result in double deductions in favor of an insurance company, but such deductions can be restored to income again only where it is clearly shown that subsequent business conditions have *released the amount* of them to the free beneficial use of the company in a real, and not in a mere bookkeeping sense. If this seemingly favorable treatment of insurance companies is to be otherwise corrected or changed, it is for Congress, and not for the courts, to amend the law.
>
> "Since the findings of fact before us do not make the clear showing, which must be required, that the statutory deduction of net reserves in prior years was restored to the *free use* of the claimant in 1913, it should not have been charged as income with the decrease in that year, and, on the record before us, the holding of the Court of Claims must be reversed." (Emphasis supplied.)

The case of *Rothensies* v. *Electric Storage Battery Co.*, 329 U.S. 296 (1946), cited by petitioner, does hold that a *refund* of previously deducted excise taxes constitutes income. It also holds that a taxpayer may *not* defeat the addition to income by claiming by way of equitable recoupment that prior years' taxes were incorrectly determined. So here the Government may not adjust a proper deduction for 1958 on the grounds that the proper depletion for prior years must first be recouped. In any event, it seems clear that equitable recoupment is unavailable as a remedy where Section 1341 applies. See *Estate of Samuel Stein* v. *Commissioner*, 37 T.C. 945 (1962).

L.O. 1032, 2 Cum. Bull. 216, also points out that the "release of reserves" must take place in the taxable year. In the instant case, respondent did not regain the "free use" of its depletion allowance deducted in prior years. It *paid out* $505,536! Its assets were *decreased.* It recovered nothing. Its mineral was still depleted and its money paid out.

The same circumstance serves to distinguish the case of *Douglas* v. *Commissioner,* 322 U.S. 275 (1944), relied upon by petitioner. There the taxpayers received advance royalties upon which they were allowed a depletion deduction. When, in a subsequent year, the *operation was abandoned* with absolutely *no mineral production* ever having been obtained, this Court upheld the validity of a Treasury Regulation which required the inclusion of the depletion deduction in income in the year of *termination or abandonment of the enterprise.* It should be noted that the Treasury Regulation there involved (and still valid) specifically provided that the inclusion in income is *only* required where there has been *no mineral production at all.* The currently effective version of that regulation (Treasury Regulation Sec. 1.612-3(a)(2)), provides that:

> "If the grant of an economic interest in a mineral deposit or standing timber with respect to which a bonus was received expires, terminates or is abandoned before there has been *any* income derived from the extraction of mineral or cutting of timber, the payee shall adjust his capital account by restoring thereto the depletion deduction taken on the bonus and a corresponding amount must be returned as income in the year of such *expiration, termination* or *abandonment.*" (Emphasis supplied.)

The Courts have carefully and strictly construed this rule and regulation and have rejected any attempt to include the amount of the prior deduction in income where there has been *any* production at all. *Dolores Crabb* v.

Commissioner, 41 B.T.A. 686 (1940), rev'd on other grounds, 119 F.2d 772 (CA 5th, 1941); *Waggoner* v. *Commissioner*, 47 B.T.A. 699 (1942); Revenue Ruling 68-78, Internal Revenue Bulletin 1968-7, p. 18. In this sense, *Douglas* accords with *United States* v. *Ludey, supra.*

In the instant case, however, respondent was producing the mineral, continues to produce it and there has been no sale of the property, or expiration, termination or abandonment of the lease or enterprise. The plain fact is that all of the rules and theories proposed by petitioner require for their application a "triggering mechanism" that results in a granting to, or release of, a tangible, permanent *benefit* to the taxpayer in the particular taxable year that can be used or otherwise applied for other purposes. That has not happened in the instant case. Respondent has suffered a burden in 1958. It *paid out* money. Until its operations terminate the adequacy of its depletion deductions taken in prior years cannot be redetermined or recalculated, even in the economic sense. That may well have been the very reason Congress did not write the law the way petitioner is asking this Court to read it.

Acceptance of petitioner's arguments could open the door to an almost unlimited number of possible contentions that income must be recognized or deductions disallowed because of factors that could vary in any given year or change the long-term economic impact of what has transpired in the past, thereby destroying the annual accounting concept that has heretofore been the keystone of our revenue laws. If such "open account" or "lifetime" theory of taxation must be applied for the benefit of the Government it must also be made available to taxpayers. If such a dramatic restructuring of the Revenue Code is to be inaugurated it must be done by Congress.

In certain highly restrictive circumstances the Congress has made provision in the Revenue Code for adjustments which recognize long-term economic impact, but those provisions, like Section 1341, are very carefully considered

and technically worded. Even then, in most instances, they only partially alleviate the problem.

The case of *Alice Phelan Sullivan Corp.* v. *United States, supra,* illustrates the point. There the taxpayer had taken a deduction for a charitable contribution in a year when tax rates were low. In a later year the contributed property was *returned* to the taxpayer which, in a classic application of the "tax benefit rule" was required to include the amount deducted at the much higher current tax rates. The result was that the taxpayer paid more tax by the contribution and recapture than if the transaction had never occurred in the first place. Although it recognized the net inequity, the Court of Claims held (at the urging of the Government), that under the law it was powerless to remedy the situation as the Congress had not provided for *tax* equaliziation.

In the instant case, the respondent paid out $505,536 and its mineral was not recovered. It is gone forever. Yet the Government is before this Court contending for an "inverse tax benefit" or "tax equalization" rule that, in *Alice Phelan Sullivan Corp.* it contended did not exist and even though the long-term result of such a rule may effect even greater distortions. It is significant here that the petitioner does not indicate how its "tax equalization" rule would be applied if the taxpayer had received no benefit from the depletion deduction in *any* of the prior years. There cannot be two rules—one for the Government and another for taxpayers. As the Court of Claims said, there may be inequities in the tax law (real or imagined) but they can only be resolved by Congress. See, *Brotherhood of Locomotive Firemen & Enginemen, et al.* v. *Chicago, Rock Island & Pacific Railroad Co.* (United States Supreme Court Nos. 16 and 18, October Term 1968, decided November 18, 1968).

Regardless of the professional and tactical ramifications of the publication of a *proposed* Treasury Regulation after a petition for *certiorari* is filed by the Government in a

case, respondent would ask the Court to note that said proposed Regulation, regardless of its validity, controverts petitioner's alternative argument in this case. Further, it is promulgated under Section 613 of the Revenue Code and makes no reference at all to Section 1341 although its language is strikingly similar and was obviously designed to overrule the decision of the Court below in this case. Although petitioner states that there was "no Treasury Regulation bearing directly on the problem" respondent submits that present Treasury Regulations, Section 1.1341-1(b)(1)(i) promulgated in 1957 does bear directly on the problem and completely supports respondent. While the petitioner disavows reliance upon the *proposed* regulation, it does take pains to stress that its validity "may well turn on the outcome of the instant case." The primary holding of this Court in the *Douglas* case was that a long standing Treasury Regulation which had subsisted from 1919 through the enactment of several revenue acts should be upheld. The same may not be said, however, for the proposed Regulation cited by petitioner. Not only was it promulgated under Section 613, which is not involved here, but its very promulgation at this particular time, when there have been no changes in the depletion provisions of the Code for many years, is highly significant. Furthermore, it usurps the province of Section 1341, especially subsection (a)(4) thereof, under which the Treasury has apparently not felt authorized nor called upon to promulgate such a regulation since the inception of the section in 1954.

In the final analysis then the proposed Regulation under Section 613 is absolutely inconsistent with Regulations, Section 1.1341-1(b)(1)(i) and thus, the Treasury itself proposes to subvert its own Regulation. Petitioner at the same time, is asking this Court to strike down a longstanding promulgated Regulation, support the *proposed* one, while at the same time citing *Douglas* for the proposition that this should not be done.

This so-called "clarifying" proposed Regulation is decidedly unusual in that it was promulgated when the decision by the Court of Appeals in this case represented the outstanding law on the question. Finally, as pointed out herein, the depletion deduction to which a taxpayer was entitled in prior years has no bearing on amounts paid out in a current year which are unrelated to the proper depletion deduction in such year.

CONCLUSION

The judgment of the Court below should be affirmed.

Respectfully submitted,

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APPENDIX

INTERNAL REVENUE CODE OF 1954:

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) In General.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

(26 U.S.C. 162.)

SEC. 1341. COMPUTATION OF TAX WHERE TAXPAYER RESTORES SUBSTANTIAL AMOUNT HELD UNDER CLAIM OF RIGHT.

(a) General Rule.—If—

(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;

(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

(3) the amount of such deduction exceeds $3,000, then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

(4) the tax for the taxable year computed with such deduction; or

(5) an amount equal to—

(A) the tax for the taxable year computed without such deduction, minus

(B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).

* * *

(b) Special Rules.—

(1) If the decrease in tax ascertained under subsection (a)(5)(B) exceeds the tax imposed by this chapter for the taxable year (computed without the deduction) such excess shall be considered to be a payment of tax on the last day prescribed by law for the payment of tax for the taxable year, and shall be refunded or credited in the same manner as if it were an overpayment for such taxable year.

(2) Subsection (a) does not apply to any deduction allowable with respect to an item which was included in gross income by reason of the sale or other disposition of stock in trade of the taxpayer (or other property of a kind which would properly have been included in the inventory of the taxpayer if on hand at the close of the prior taxable year) or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. This paragraph shall not apply if the deduction arises out of refunds or repayments with respect to rates made by a regulated public utility (as defined in section

7701(a)(33) without regard to the limitation contained in the last two sentences thereof) if such refunds or repayments are required to be made by the Government, political subdivision, agency, or instrumentality referred to in such section, or by an order of a court, or are made in settlement of litigation or under threat or imminence of litigation. This paragraph shall not apply if the deduction arises out of payments or repayments made pursuant to a price redetermination provision in a subcontract entered into before January 1, 1958, between persons other than those bearing the relationship set forth in section 267(b), if the subcontract containing the price redetermination provision is subject to statutory renegotiation and section 1481 (relating to mitigation of effect of renegotiation of Government contracts) does not apply to such payment or repayment solely because such payment or repayment is not paid or repaid to the United States or any agency thereof.

* * *

Treasury Regulations on Income Tax (1954 Code):

SEC. 1.1341-1—*Restoration of amounts received or accrued under claim of right.*— (a) *In general.*—

(1) If, during the taxable year, the taxpayer is entitled under other provisions of chapter 1 of the Internal Revenue Code of 1954 to a deduction of more than $3,000 because of the restoration to another of an item which was included in the taxpayer's gross income for a prior taxable year (or years) under a claim of right, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year shall be the tax provided in paragraph (b) of this section.

(2) For the purpose of this section "income included under a claim of right" means an item included in gross income because it appeared from all the facts available in the year of inclusion that the taxpayer had an unrestricted right to such item,

and "restoration to another" means a restoration resulting because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item (or portion thereof).

* * *

(b) *Determination of tax.*— (1) Under the circumstances described in paragraph (a) of this section, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year shall be the lesser of—

(i) The tax for the taxable year computed under section 1341(a)(4), that is, with the deduction taken into account, or

(ii) The tax for the taxable year computed under section 1341(a)(5), that is, without taking such deduction into account, minus the decrease in tax * * * for the prior taxable year (or years) which would result solely from the exclusion from gross income of all or that portion of the income included under a claim of right to which the deduction is attributable.

* * *

(26 C.F.R. 1.1341-1)

Congressional Committee Reports

HOUSE REPORT No. 1337, 83D CONGRESS, 2D SESSION (1954), pp. 86, 87.

D. Claim of Right (sec. 1341)

Under present law if a taxpayer is obliged to repay amounts which he had received in a prior year and included in income because it appeared that he had an unrestricted right to such amounts, he may take a deduction in the year of restitution. In many instances of this nature, the deduction allowable in the later year does not compensate the taxpayer adequately for the tax paid in the earlier year.

The committee's bill provides that if the amount restored exceeds $3,000, the taxpayer may recompute the tax for the prior year, excluding from income the amount re-

paid. This is an alternative to taking the deduction in the year of restitution. The $3,000 limitation is imposed for administrative reasons. Moreover, with smaller amounts, excluding the repaid amount from the earlier year's income is likely to have little, if any, tax advantage over taking a deduction in the year of restitution.

HOUSE REPORT No. 1337, 83D CONGRESS, 2D SESSION (1954), PP. A294, A295.

PART V—CLAIM OF RIGHT

SECTION 1341. Computation of tax where taxpayer restores substantial amount held under claim of right.

If the taxpayer included an item in gross income in one taxable year, and in a subsequent taxable year he becomes entitled to a deduction because the item or a portion thereof is no longer subject to his unrestricted use, and the amount of the deduction is in excess of $3,000, the tax for the subsequent year is reduced by either the tax attributable to the deduction or the decrease in the tax for the prior year attributable to the removal of the item, whichever is greater. Under the rule of the *Lewis* case (340 U.S. 590 (1951)), the taxpayer is entitled to a deduction only in the year of repayment.

In the case of a cash-basis taxpayer, in order to be entitled to a deduction in the later year, the amount must be repaid. However, in the case of an accrual-basis taxpayer, if the item was accrued but never received, the section applies when the deduction accrues in the later year although there is, of course, no amount to be repaid. Where an accrual-basis taxpayer has received the item, the time of accrual of the deduction again determines when the section comes into operation.

The section will not apply in the case of a bad debt. Even though a debt is uncollectible, the taxpayer does not lose his unrestricted right to the money. The section is

specifically made inapplicable to sales of inventory, stock in trade, etc. An accrual basis taxpayer may instead estimate sales returns and guaranties in accordance with section 462.

The section will apply to cases of transferee liability such as *Arrowsmith* v. *Commissioner* (344 U.S. 6 (1952)). Thus, while the deduction in the current year is capital in nature, the taxpayer is not deprived of all relief because his tax is reduced at least to the extent of the tax attributable to the prior inclusion.

In computing the tax reduction for the prior taxable year attributable to the removal of the item in question, if the earlier year would otherwise be closed, no other items may be adjusted. However, to the extent that adjusted gross income or taxable income may be changed, items such as the medical and charitable deductions which are dependent upon income may also be affected.

Whenever the decrease in tax for the prior year is greater than the tax for the taxable year (without the deduction attributable to the item in question), the excess is treated as a payment of tax on the last day prescribed by law for payment for the taxable year and will be refunded or credited as an overpayment for that year.

SENATE REPORT NO. 1622, 83D CONGRESS, 2D SESSION (1954), P. 118.

D. CLAIM OF RIGHT (sec. 1341).

(1) House changes accepted by committee.

Under present law if a taxpayer is obliged to repay amounts which he had received in a prior year and included in income because it appeared that he had an unrestricted right to such amounts, he may take a deduction in the year of restitution. In many instances of this nature, the deduction allowable in the later year does not compensate the taxpayer adequately for the tax paid in the earlier year.

The House and your committee's bill provide that if the amount restored exceeds $3,000, the taxpayer may recompute the tax for the prior year, excluding from income the amount repaid. This is an alternative to taking the deduction in the year of restitution. The $3,000 limitation is imposed for administrative reasons. Moreover, with amounts of $3,000 or under, the effect of excluding the repaid amount from the earlier year's income is likely to have little, if any, tax advantage over taking a deduction in the year of restitution. This section is inapplicable to refunds, allowances, bad debts, etc., pertaining to sales of inventory or stock in trade which may be provided for under section 462 relating to reserves.

(2) Change made by committee.

Your committee's bill provides that the exclusion of refunds pertaining to inventory sales will not exclude from the benefits of this section refunds made by a regulated public utility where the refunds are required to be made by the regulatory body, such as the Federal Power Commission. It is made clear, for example, that refunds of charges for the sale of natural gas under rates approved temporarily would be eligible for the benefits of this section.

SENATE REPORT No. 1622, 83D CONGRESS, 2D SESSION (1954), PP. 451, 452.

PART V—CLAIM OF RIGHT

SECTION 1341. Computation of tax where taxpayer restores substantial amount held under claim of right.

Except for one revision this section corresponds to section 1341 of the House bill.

If the taxpayer included an item in gross income in one taxable year, and in a subsequent taxable year he becomes entitled to a deduction because the item or a por-

tion thereof is no longer subject to his unrestricted use, and the amount of the deduction is in excess of $3,000, the tax for the subsequent year is reduced by either the tax attributable to the deduction or the decrease in the tax for the prior year attributable to the removal of the item, whichever is greater. Under the rule of the *Lewis* case (340 U.S. 590 (1951)), the taxpayer is entitled to a deduction only in the year of repayment.

In the case of a cash-basis taxpayer, in order to be entitled to a deduction in the later year, the amount must be repaid. However, in the case of an accrual-basis taxpayer, if the item was accrued but never received, the section applies when the deduction accrues in the later year although there is, of course, no amount to be repaid. Where an accrual-basis taxpayer has received the item, the time of accrual of the deduction again determines when the section comes into operation.

The section will not apply in the case of a bad debt. Even though a debt is uncollectible, the taxpayers does not lose his unrestricted right to the money. This section is specifically made inapplicable to sales of inventory, stock in trade, except refunds made by a regulated public utility in certain cases. An accrual-basis taxpayer may instead estimate sales returns and guaranties in accordance with section 462.

Your committee has provided that the exclusion of refunds pertaining to inventory sales will not exclude from the benefits of this section refunds made by a regulated public utility (as defined in sec. 1503 (c)) if such refunds or repayments are required to be made by the government, political subdivision, agency or instrumentality referred to in such section. Thus refunds of charges for the sale of natural gas under rates approved temporarily would be eligible for the benefits of this section.

The section will apply to cases of transferee liability such as *Arrowsmith* v. *Commissioner* (344 U.S. 6 (1952)).

Thus, while the deduction in the current year is capital in nature, the taxpayer is not deprived of all relief because his tax is reduced at least to the extent of the tax attributable to the prior inclusion.

In computing the tax reduction for the prior taxable year attributable to the removal of the item in question, if the earlier year would otherwise be closed, no other items may be adjusted. However, to the extent that adjusted gross income or taxable income may be changed, items such as the medical and charitable deductions which are dependent upon income may also be affected.

Whenever the decrease in tax for the prior year is greater than the tax for the taxable year (without the deduction attributable to the item in question), the excess is treated as a payment of tax on the last day prescribed by law for payment for the taxable year and will be refunded or credited as an overpayment for that year.

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IN THE

Supreme Court of the United States

October Term 1968

No. 280

UNITED STATES OF AMERICA,
Petitioner,

v.

SKELLY OIL COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

PETITION FOR REHEARING

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IN THE

United States Court of Appeals

October Term 1968

No. 280

UNITED STATES OF AMERICA,

Petitioner,

v.

SKELLY OIL COMPANY,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

PETITION FOR REHEARING

Skelly Oil Company, respondent in this proceeding, respectfully petitions under Rule 58 for a rehearing by this Honorable Court of this cause and reconsideration of its opinion herein dated April 21, 1969.

Preliminary Statement

In its opinion, dated April 21, 1969, the Court held that respondent, Skelly Oil Company, in computing its Federal income tax liability for 1958, may not deduct the full amount of $505,536.54 which it was required to repay to customers who purchased its natural gas in the years 1952 through 1957. The Court held that pursuant to the Revenue Code of 1954 the deduction in 1958 must be reduced by the deple-

tion deductions taken in the prior years when the gas was sold and the proceeds included in gross income under claim of right.

Through this petition respondent respectfully urges the Court to grant a rehearing in this case so as to consider the serious Constitutional questions raised by the opinion of April 21, 1969, the previously misapprehended indications of Congressional intent in enacting Section 1341 of the 1954 Revenue Code, and the inevitable conclusion inherent in said opinion, that respondent is entitled to judgment under Section 1341(a)(5) of the Revenue Code.

Reasons for Granting Rehearing

I. The Opinion of the Court Raises Important Constitutional Questions With Regard To Taxation of Property.

In its opinion of April 21, 1969, the Court held that respondent, Skelly Oil Company, was not entitled to a full deduction in 1958 for the $505,536.54 it paid in that year to customers who had purchased natural gas from it in the years 1952 through 1957. The Court held that for deduction purposes in 1958, the amount repaid must be reduced by 27½%, representing the depletion deductions allowed in the prior years when the gas was sold even though no particular provision of the income tax law defining income and prescribing deductions requires such an adjustment. The Court's opinion was that any other approach would be equivalent to allowing Skelly a "double deduction," citing *Charles Ilfeld Co.* v. *Hernandez*, 292 U.S. 62 (1934) and *United States* v. *Ludey*, 274 U.S. 295 (1927). The Court also held that this view did not violate the annual accounting concept of *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359 (1931), citing *Arrowsmith* v. *Commissioner*, 344 U.S. 6 (1952).

Respondent, Skelly Oil Company, submits that the *Ilfeld*, *Ludey* and *Arrowsmith* cases have no bearing on, and cannot be cited in context with, the annual accounting concept without raising serious Constitutional questions. Contrary to general assumption, the annual accounting concept for the determination of *income* taxes was not developed for purposes of convenience, nor is it a purely judicial concept or doctrine. It arose because of the Constitutional restrictions imposed upon the levying of direct taxes without apportionment or in accordance with the Census or Enumeration. Constitution of the United States, Article I, Section 2; Article I, Section 9. *Pollock* v. *Farmers Loan & Trust Co.*, 157 U.S. 429 (1895). These restrictions could only be avoided by the Sixteenth Amendment to the Constitution which, in effect, overruled *Pollock* and categorized the income tax as an excise tax within the purview of Article I, Section 8 of the Constitution. *Brushaber* v. *Union Pacific Railroad Co.*, 240 U.S. 1 (1916).

As an *excise* tax, however, the income tax must be levied on an annual basis and on the results of annual operations, and must be determined strictly in accordance with the definitions of income and deductions precisely prescribed by the statute. Therefore, income subject to tax and deductions allowed therefrom are peculiarly creatures of legislation and cannot be "amended" by reference to extrinsic matters without conflicting with the other provisions of the Constitution. See, *Stanton* v. *Baltic Mining Co.*, 240 U.S. 103 (1916); *Stratton's Independence* v. *Howbert*, 231 U.S. 399 (1913). As the Court pointed out in *Brushaber*, the Sixteenth Amendment merely relieved the income tax from the burden of reference to the source of the income subjected to the tax (240 U.S. 1 at 19), thus constituting the income tax a true excise subject only to the Constitutional requirements of uniformity of application and a determination thereof strictly as legislated by the Congress. *Burnet* v. *Thompson Oil & Gas Co.*, 283 U.S. 301 (1931). Adjustment of the specified categories of income or other-

wise allowable deductions of a taxable year by reference to events of prior or subsequent years takes the question out of the category of "excise" and raises the question of the *source* of the income or deductions involved, and the resulting Constitutional questions of the direct taxation of property without apportionment. This is the rationale and sole justification for the decisions of this Court in *Ilfeld, Ludey* and *Arrowsmith,* wherein the inquiry was whether property was being taxed without apportionment upon its final disposal by sale or liquidation. See, *Burnet* v. *Thompson Oil & Gas Co., supra,* at pages 306-308. See also, *Burnet* v. *Whitehouse,* 283 U.S. 148 (1931) and *Burnet* v. *Logan,* 283 U.S. 404 (1931).

This Constitutional limitation is precisely the reason why the Congress has always provided that the tax impact of the depletion deduction for minerals and all other deductions must be determined on an annual basis by reference to the *operations* of that year regardless of prior or subsequent events. To allow otherwise would raise the Constitutional questions of the taxation of propery or capital. *Eisner* v. *Macomber,* 252 U.S. 189 (1920). See, *Penn Mutual Indemnity Co.* v. *Commissioner,* 32 TC 653 at 659-667 (1959) and d., 277 F.2d 16 (CA 3rd, 1960).

In the instant case, respondent, Skelly Oil Company, has been doubly penalized. Its mineral is gone and the money has been paid out. No other taxpayer has been so subjected to the deprivation of its mineral and the loss of its money. As compared to taxpayers who produced and sold depletable minerals in the taxable years 1952 through 1957, and were not forced to refund part of the purchase price, Skelly has been discriminated against and its property taxed without reference to the Constitutional requirements of apportionment or enumeration. It is unconstitutional for the Court to go outside the provisions of the law to levy an additional *income* tax on Skelly for 1958 by denying it a proper deduction specifically sanctioned by Congress, and,

in effect, tax as income an amount not realized in the taxable year. *Eisner* v. *Macomber, supra.* To do so, in substance, amounts to the taxation of property. In this case the issue has been treated as if dollars had been depleted rather than the mineral reserve.

The opinion of the Court has failed to apply the clear and unambiguous provisions of the income tax law and thus has unconstitutionally deprived respondent of its property without due process of law. It has nullified the entire subsection 1341(a)(4) of the 1954 Revenue Code, a nullification which the Constitution specifically prohibits so long as only Article I, Section 8, is invoked.

With particular reference to the *Arrowsmith* case, it should be noted that there the taxpayer was *allowed* a deduction precisely commensurate with the amount previously included in "gross income"—the measure of the tax, and the taxing power, provided by the Constitution and the Sixteenth Amendment thereto, and precisely the standard continued in the Revenue Code by Congress when it enacted Section 1341.

II. The Adjustment of the Deduction For 1958 By the Amount of Depletion Sustained in Prior Years is Unconstitutional.

In its opinion of April 21, 1969, the Court held that the deduction for 1958 must be adjusted to conform with the amount taxed when the money was originally received on the grounds that 27½% of said receipts were "in reality tax exempt." Respondent, Skelly Oil Company, submits that the proceeds from the sale of gas in the prior years were not tax exempt to the extent of 27½%, but rather that 27½% thereof was allowed as a deduction for those particular years under the provisions of the Internal Revenue Code. Once those years were closed, however, and the taxes with regard thereto finalized, the previously allowed deple-

tion deduction became part of respondent's recovered capital and no provision of the law permits the adjustment thereof. *Burnet* v. *Thompson Oil & Gas Co., supra.* To do so conflicts with the Constitution. The Treasury Regulations have recognized this restriction and have always maintained that depletion deductions may not be adjusted, at law or in equity, after the close of the taxable year or years when they were properly allowed.

In its opinion the Court stated that "We cannot believe that Congress intended to give taxpayers a deduction for refunding money that was not taxed when received." Respondent submits that the statute as written does not predicate the deduction, allowed by the express provisions of the Internal Revenue Code, upon the *taxing* of the income when received. Congress could not have so intended because to do so would have removed the item in question from the purview of Article I, Section 8, and placed it within the scope of Article I, Sections 2 and 9, and thus subject it to the restrictions imposed by those sections. Even Section 1341(a)(5) does not permit the tax liability for a prior year to be recomputed and *reimposed.* Adjustments may only be made in the current year's tax by reference to the prior year's computation. Subsection (a)(5) prescribes the computation of the tax for the *current* year. It provides that any reduction in tax for a prior year due to an exclusion from gross income for that year will serve to reduce the *current* year's tax—a tax credit. To provide otherwise would violate the annual accounting requirement of the statute and would be unconstitutional!

The Court, however, has in its opinion required respondent to do what even the Congress cannot constitutionally require—reopen prior years in order to compute the tax for the current year by disallowing deductions taken in those prior years to which the respondent was and is rightfully entitled. There is a serious question as to

whether Congress itself could constitutionally require by statute that a current deduction, otherwise allowable, must be reduced by reference to the tax ramifications of a prior year, or whether Congress itself could constitutionally deprive a taxpayer of a deduction taken in a prior year to which it was rightfully entitled when taken.

III. The Opinion of the Court Disregards the Specifically Stated Intention of Congress.

In its opinion, dated April 21, 1969, the Court stated as grounds for its decision that "(h)ere, the taxpayer always wins and the Government always loses. We cannot believe that Congress would have intended such an inequitable result." Regardless of the question of whether any equitable principles are applicable in the operation of the tax law (see *McGinty* v. *Commissioner*, 325 F.2d 820 (CA 2nd, 1963)), this view is diametrically opposite to the precise language of the statute, the Regulations and the Congressional Committee Reports. The Committee Reports specifically state that a taxpayer using Section 1341 must reduce his tax for the year of restoration by *either* the tax attributable to the deduction, *or* the decrease in the prior year's tax attributable to the removal of the item, "whichever is greater." H. Rept. No. 1337, 83d Cong. 2d Sess. (1954), p. A294; Sen. Rept. No. 1622, 83d Cong. 2d Sess. (1954), p. 451.

Section 1341(a)(3) of the 1954 Revenue Code specifically provides that the tax for the taxable year shall be the *lesser* of either the tax computed with a current deduction or a recomputation of the prior year's tax after excluding the amount restored from gross income.

Thus, Congress in enacting the legislation clearly stated that the taxpayer *must* always win and the Government *must* always lose when Section 1341 is applied. If it now

appears that the amount of money involved may be too large, the Congress alone may supply the remedy.

Despite the Court's statement (Opinion, pp. 7, 8) that "* * * no attempt is being made to require the tax savings from the deduction to equal the tax consequences of the receipts in prior years," that is precisely what has been held from a pure mathematical standpoint. Unless some other factor, such as a change in tax rates, intervenes, under the Court's opinion the mathematical effect will *always* be tax equalization. Congress refused to legislate this very proposition. This is the weakness of the *proposed* Treasury Regulation cited by the Court, and is contrary to the intent and purpose of Congress which can be strict or lavish in its definition of income or allowance of deduction *for a taxable year*. *Lewyt Corp.* v. *Commissioner*, 349 U.S. 237 (1955).

It has always been axiomatic in the application of the tax laws, which have no genesis in common or natural law, that the precise terms of the taxing statutes must be applied as written. If there is any room for equity in the tax law, this is the only equitable principle which can apply. *Cf. D. B. Anders* v. *Commissioner*, 48 T.C. 815, at 820-823 (1967). To allow the subjective views or unilateral interpretations of the tax collector, or the Courts, to become paramount to the statutory provisions is to destroy the validity, relevancy and credibility of the self-assessment method of revenue collection which heretofore has been the distinctive cornerstone of the United States revenue system.

No philosophical "double deduction" exists where two separate deductions, for separate purposes, are allowed under separate provisions of the Revenue Code. *D. B. Anders* v. *Commissioner, supra.* To determine each year's tax by reference to prior or subsequent events or years, and justify the reference by an alleged need to avoid a "double deduction", is to ignore the entire scheme of the Revenue Code and constitute partisan expediency the mother of taxation.

The overwhelming thrust of the Court's opinion of April 21, 1969, is that there is some nebulous standard of fairness or equity which overrides the terms of the tax statutes whenever the tax collector feels that the statute as written provides excessive benefits to taxpayers. Thus the even-handed policy expressed in *Lewyt Corp.* v. *Commissioner, supra,* at 240, has been revoked *in silentio,* and taxpayers may no longer claim the protection of clear statutory provisions if the *Government* poses an objection. At the same time, the Court, by citing *Alice Phelan Sullivan Corp.* v. *United States,* 381 F. 2d 399 (Ct. Cls. 1967), with approval has reaffirmed the teachings of *Healy* v. *Commissioner,* 345 U.S. 278 (1953), and *United States* v. *Lewis,* 340 U.S. 590 (1951), that the statute must be strictly applied as enacted when the detriment falls upon the *taxpayer.* If it is now the law that taxpayers may not rely upon the express provisions of the tax law in calculating their allowance to the sovereign, that fact should be clearly enunciated. The sword of taxation has historically been double-edged—if one edge is now to be dulled, taxpayers are entitled to know about it in clear and certain terms, or this Court should henceforth be prepared to review all tax cases where the Government deems the equities sufficient to withhold the statute in its favor.

The very fact that the Court's opinion points out that the adjustment therein mandated will "affect only a few cases" indicates the existence of a Constitutional question with regard to the appropriateness of the required adjustment even under the broad income-excise tax scope of Article I, Section 8 of the Constitution, which requires that under that provision, the exercise of the power must be uniform in its application. Uniformity of application would seem to require that one taxpayer, one class of taxpayer, or one type of industry not be discriminated against in the application of a taxing statute.

IV. The Opinion of The Court Requires The Application of Section 1341(a)(5) of The Internal Revenue Code of 1954 and Thus Affirmance of the Judgment Below.

In its opinion of April 21, 1969, the Court held that the amount of the "deduction" referred to in Section 1341(a)(4) of the Revenue Code of 1954 need not "necessarily" be equal to the "item" previously included in gross income mentioned in Section 1341(a)(1) and, thus, that the amount of the deduction under 1341(a)(4) must be determined by reference to the other sections of the Code. Apparently the Court felt that the stipulation of the parties that Section 1341(a)(5) does not apply to this case precluded reference to that subsection in ascertaining the intention of Congress in enacting Section 1341. (Opinion, p. 4) Respondent submits that the parties stipulated that Section 1341(a)(5) does not apply in determining respondent's tax liability for 1958, but did not stipulate that the intent of Congress is not manifested by that section of the Code. Reference to Section 1341(a)(5) demonstrates conclusively that in enacting Section 1341, the Congress used the terms "item" and "deduction" interchangeably. If this is not so there is a serious question as to the amount of the "item" previously included in gross income for purposes of determining the application of Section 1341(a)(5) which provides for the determination of the reduction in tax thereunder by reference to "an amount equal to the tax for the taxable year computed without *such deduction,* minus *** the decrease in tax *** which would result *solely* from the exclusion of such *item* *** from gross income for such prior taxable year (or years)." (Emphasis supplied.) It is absolutely clear here that if the "deduction" is not the same as the "item" previously included, then the tax must be computed under Section 1341(a)(5) by reference to an excluded amount which is, under the Court's opinion, not necessarily

the same as the amount deductible under Section 1341 (a)(4). To put it another way, if, under the Court's opinion, the current year deduction must be reduced by the application of other Code sections, the excluded *item* cannot be so adjusted under the "double deduction" theory. As the Court correctly points out, the term "item" is first mentioned in Section 1341(a)(1) and is the "item" included in "gross income" in the year of receipt. (Opinion, p. 5) The "item" previously included in "gross income" is the full proceeds of the sale of the mineral and that "item" must be excluded under Section 1341(a)(5). Accordingly, pursuant to the Court's opinion, Section 1341(a)(5) provides the greater benefit and it is mandatory that the subsection be applied regardless of the stipulation between the parties. The Court should have so held.

If the stipulations of the parties are to be binding in the premises, the record shows that the parties stipulated the issue to be whether Section 1341(a)(4) requires an adjustment for depletion of the "otherwise allowable deduction" for the amount repaid in 1958. The Government thus conceded long ago that "other portions" of the Revenue Code do not require the adjustment now mandated by the Court. As this Court has held that Section 1341 (a)(4) itself does not require the adjustment, the opinion should uphold the respondent.

CONCLUSION

In accordance with the foregoing, it is respectfully requested that this Petition for Rehearing be granted and the questions discussed herein be set down for hearing and briefing by the parties.

Respectfully submitted,

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Certificate of Counsel

I hereby certify that I am counsel for respondent in the above-entitled cause and that the foregoing Petition for Rehearing is presented in good faith and not for delay.

ROBERT J. CASEY

SUPREME COURT OF THE UNITED STATES

No. 280.—October Term, 1968.

United States, Petitioner, v. Skelly Oil Company. | On Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit.

[April 21, 1969.]

Mr. Justice Marshall delivered the opinion of the Court.

During its tax year ending December 31, 1958, respondent refunded $505,536.54 to two of its customers for overcharges during the six preceding years. Respondent, an Oklahoma producer of natural gas, had set its prices during the earlier years in accordance with a minimum price order of the Oklahoma Corporation Commission. After that order was vacated as a result of a decision of this Court, *Michigan Wisconsin Pipe Line Co.* v. *Corporation Comm'n of Oklahoma*, 355 U. S. 425 (1958), respondent found it necessary to settle a number of claims filed by its customers; the repayments in question represent settlements of two of those claims. Since respondent had claimed an unrestricted right to its sales receipts during the years 1952 through 1957, it had included the $505,536.54 in its gross income in those years. The amount was also included in respondent's "gross income from the property" as defined in § 613 of the Internal Revenue Code of 1954, the section which allows taxpayers to deduct a fixed percentage of certain receipts to compensate for the depletion of natural resources from which they derive income. Allowable percentage depletion for receipts from oil and gas wells is fixed at 27½% of the "gross income from the property." Since respondent claimed and the Commissioner allowed percentage

depletion deductions during these years, 27½% of the receipts in question was added to the depletion allowances to which respondent would otherwise have been entitled. Accordingly, the actual increase in respondent's taxable income attributable to the receipts in question was not $505,536.54, but only $366,513.99. Yet, when respondent made its refunds in 1958, it attempted to deduct the full $505,536.54. The Commissioner objected and assessed a deficiency. Respondent paid and, after its claim for a refund had been disallowed, began the present suit. The Government won in the District Court, 255 F. Supp. 228 (D. C. N. D. Okla. 1966), but the Court of Appeals for the Tenth Circuit reversed, 392 F. 2d 128 (1968). Upon petition by the Government, we granted certiorari, 393 U. S. 820 (1968), to consider whether the Court of Appeals decision had allowed respondent "the practical equivalent of double deduction," *Charles Ilfeld Co.* v. *Hernandez*, 292 U. S. 62, 68 (1934), in conflict with past decisions of this Court and sound principles of tax law. We reverse.

I.

The present problem is an outgrowth of the so-called "claim-of-right" doctrine. Mr. Justice Brandeis, speaking for a unanimous Court in *North American Oil Consolidated* v. *Burnet*, 286 U. S. 417, 424 (1932), gave that doctrine its classic formulation: "If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged to restore its equivalent." Should it later appear that the taxpayer was not entitled to keep the money, Mr. Justice Brandeis explained, he would be entitled to a deduction in the year of repayment; the taxes due for the year of receipt would

not be affected. This approach was dictated by Congress' adoption of an annual accounting system as an integral part of the tax code. See *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, 365–366 (1931). Of course, the tax benefit from the deduction in the year of repayment might differ from the increase in taxes attributable to the receipt; for example, tax rates might have changed, or the taxpayer might be in a different tax "bracket." See *Healy* v. *Commissioner*, 345 U. S. 278, 284–285 (1953). But as the doctrine was originally formulated, these discrepancies were accepted as an unavoidable consequence of the annual accounting system.

Section 1341 of the 1954 Code was enacted to alleviate some of the inequities which Congress felt existed in this area.[1] See H. R. Rep. No. 1337, 83d Cong., 2d Sess.,

[1] Section 1341 (a) provides:

"If—

"(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;

"(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

"(3) the amount of such deduction exceeds $3,000,

"then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

"(4) the tax for the taxable year computed with such deduction; or

"(5) an amount equal to—

"(A) the tax for the taxable year computed without such deduction, minus

"(B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).

"For purposes of paragraph (5)(B), the corresponding provisions of the Internal Revenue Code of 1939 shall be chapter 1 of such code

86–87 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess., 118–119 (1954). As an alternative to the deduction in the year of repayment[3] which prior law allowed, § 1341 (a)(5) permits certain taxpayers to recompute their taxes for the year of receipt. Whenever § 1341 (a)(5) applies, taxes for the current year are to be reduced by the amount taxes were increased in the year or years of receipt because the disputed items were included in gross income. Nevertheless, it is clear that Congress did not intend to tamper with the underlying claim-of-right doctrine; it only provided an alternative for certain cases in which the new approach favored the taxpayer. When the new approach was not advantageous to the taxpayer, the old law was to apply under § 1341 (a)(4).

In this case, the parties have stipulated that § 1341 (a)(5) does not apply. Accordingly, as the courts below recognized, respondent's taxes must be computed under § 1341 (a)(4) and thus, in effect, without regard to the special relief Congress provided through the enactment of § 1341. Nevertheless, respondent argues, and the Court of Appeals seems to have held, that the language used in § 1341 requires that respondent be allowed a deduction for the full amount it refunded to its customers. We think the section has no such significance.

(other than subchapter E, relating to self-employment income) and subchapter E of chapter 2 of such code."

Section 1341 (b)(2) contains an exclusion covering certain cases involving sales of stock in trade or inventory. However, because of special treatment given refunds made by regulated public utilities, both parties agree that § 1341 (b)(2) is inapplicable to this case and that, accordingly, § 1341 (a) applies.

[3] In the case of an accrual-basis taxpayer, the legislative history makes it clear that the deduction is allowable at the proper time for accrual. H. R. Rep. No. 1337, 83d Cong., 2d Sess., A294 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess., 451–452 (1954).

In describing the situations in which the section applies, § 1341 (a)(2) talks of cases in which "a deduction is allowable for the taxable year because it was established after the close of [the year or years of receipt] that the taxpayer did not have an unrestricted right to such item . . . ." The "item" referred to is first mentioned in § 1341 (a)(1); it is the item included in gross income in the year of receipt. The section does not imply in any way that the "deduction" and the "item" must necessarily be equal in amount. In fact, the use of the words "a deduction" and the placement of § 1341 in subchapter Q—the subchapter dealing largely with side-effects of the annual accounting system—make it clear that it is necessary to refer to other portions of the Code to discover how much of a deduction is allowable. The regulations promulgated under the section make the necessity for such a cross-reference clear. Treas. Reg. § 1.1341–1 (1957). Therefore, when § 1341 (a)(4)—the subsection applicable here—speaks of "the tax . . . computed with such deduction," it is referring to the deduction mentioned in § 1341 (a)(2); and that deduction must be determined not by any mechanical equation with the "item" originally included in gross income, but by reference to the applicable sections of the Code and the case law developed under those sections.

II.

There is some dispute between the parties about whether the refunds in question are deductible as losses under § 165 of the 1954 Code or as business expenses under § 162.[3] Although in some situations the distinction may have relevance, cf. *Equitable Life Ins. Co. of*

[3] The Commissioner has long recognized that a deduction under some section is allowable. G. C. M. 16730, XV–1 Cum. Bull. 179 (1936).

Iowa v. *United States*, 340 F. 2d 9 (C. A. 8th Cir. 1965), we do not think it makes any difference here. In either case, the Code should not be interpreted to allow respondent "the practical equivalent of double deduction," *Charles Ilfeld Co.* v. *Hernandez*, 292 U. S. 62, 68 (1934), absent a clear declaration of intent by Congress. See *United States* v. *Ludey*, 274 U. S. 295 (1927). Accordingly, to avoid that result in this case, the deduction allowable in the year of repayment must be reduced by the percentage depletion allowance which respondent claimed and the Commissioner allowed in the years of receipt as a result of the inclusion of the later-refunded items in respondent's "gross income from the property" in those years. Any other approach would allow respondent a total of $1.27½ in deductions for every $1 refunded to its customers.

Under the annual accounting system dictated by the Code, each year's tax must be definitively calculable at the end of the tax year. "It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the Government, at regular intervals." *Burnet* v. *Sanford & Brooks Co.*, *supra*, at 365. In cases arising under the claim-of-right doctrine, this emphasis on the annual accounting period normally requires that the tax consequences of a receipt should not determine the size of the deduction allowable in the year of repayment. There is no requirement that the deduction save the taxpayer the exact amount of taxes he paid because of the inclusion of the item in income for a prior year. See *Healy* v. *Commissioner*, *supra*.

Nevertheless, the annual accounting concept does not require us to close our eyes to what happened in prior years. For instance, it is well settled that the prior year may be examined to determine whether the repayment gives rise to a regular loss or a capital loss. *Arrow-*

smith v. *Commissioner*, 344 U. S. 6 (1952). The rationale for the *Arrowsmith* rule is easy to see; if money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair tax windfall if repayments were generally deductible from receipts taxable at the higher rate applicable to ordinary income. The Court in *Arrowsmith* was unwilling to infer that Congress intended such a result.

This case is really no different.[4] In essence, oil and gas producers are taxed on only 72½% of their "gross income from the property" whenever they claim percentage depletion. The remainder of their oil and gas receipts is in reality tax exempt. We cannot believe that Congress intended to give taxpayers a deduction for refunding money that was not taxed when received. Cf. *Maurice P. O'Meara*, 8 T. C. 622, 634–635 (1947). Accordingly, *Arrowsmith* teaches that the full amount of the repayment cannot, in the circumstances of this case, be allowed as a deduction.

This result does no violence to the annual accounting system. Here, as in *Arrowsmith*, the earlier returns are not being reopened. And no attempt is being made to require the tax savings from the deduction to equal the

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[4] The analogy would be even more striking if in *Arrowsmith* the individual taxpayer had not utilized the alternative tax for capital gains, as they were permitted to do by what is now § 1201 of the 1954 Code. Where the 25% alternative tax is not used, individual taxpayers are taxed at ordinary rates on 50% of their capital gains. See § 1202. In such a situation, the rule of the *Arrowsmith* case prevents taxpayers from deducting 100% of an item refunded when they were taxed on only 50% of it when it was received. Although *Arrowsmith* prevents this inequitable result by treating the repayment as a capital loss, rather than by disallowing 50% of the deduction, the policy behind the decision is applicable in this case. Here it would be inequitable to allow a 100% deduction when only 72½% was taxed on receipt.

tax consequences of the receipts in prior years.[5] In addition, the approach here adopted will affect only a few cases. The percentage depletion allowance is quite unusual; unlike most other deductions provided by the Code, it allows a fixed portion of gross income to go untaxed. As a result, the depletion allowance increases in years when disputed amounts are received under claim of right; there is no corresponding decrease in the allowance because of later deductions for repayments.[6] Therefore, if a deduction for 100% of the repayments were allowed, every time money is received and later repaid the taxpayer would make a profit equivalent to the taxes on 27½% of the amount refunded. In other situations when the taxes on a receipt do not equal the tax benefits of a repayment, either the taxpayer or the Government may, depending on circumstances, be the beneficiary. Here, the taxpayer always wins and the Government always loses. We cannot believe that Congress would have intended such an inequitable result.

The parties have stipulated that respondent is entitled to a judgment for $20,932.64 plus statutory interest for claims unrelated to the matter in controversy here; the

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[5] Compare the analogous approach utilized under the "tax benefit" rule. *Alice Phelan Sullivan Corp. v. United States*, 381 F. 2d 399 (Ct. Cl. 1967); see Internal Revenue Code of 1954 § 111. In keeping with the analogy, the Commissioner has indicated that the Government will only seek to reduce the deduction in the year of repayment to the extent that the depletion allowance attributable to the receipt directly or indirectly reduced taxable income. Proposed Treas. Reg. § 1.613–2 (c) (8), 33 Fed. Reg. 10702–10703 (1968).

[6] The 10% standard deduction mentioned by the dissent, *post*, at 6, differs in that it allows as a deduction a percentage of adjusted gross income, rather than of gross income. See § 141; cf. §§ 170, 213. As a result, repayments may in certain cases cause a decrease in the 10% standard deduction allowable in the year of repayment, assuming that the repayment is of the character to be deducted in calculating adjusted gross income. See § 62.

District Court entered a judgment for that amount. Accordingly, the judgment of the Court of Appeals is reversed and the case is remanded to that court with instructions that it be returned to the District Court for re-entry of the original District Court judgment.

Reversed.

SUPREME COURT OF THE UNITED STATES

No. 280.—October Term, 1968.

United States, Petitioner, v. Skelly Oil Company. } On Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit.

[April 21, 1969.]

Mr. Justice Douglas, dissenting.

I share Mr. Justice Stewart's views as to this case and add only a word.

If we sat in chancery reviewing tax cases, much of what the Court says would have appeal. But we do not sit to do equity in tax cases; that is one of Congress' main concerns.

The search for equity in the tax laws is wondrous and elusive. As Edmond Cahn said "those only are equal whom the law has elected to equalize." Cahn, The Sense of Injustice, 14 (1949).

Percentage depletion had its roots in granting a reward to men who go into undeveloped territory in search of oil and gas. But today it is granted anyone who has an interest in oil or gas; the beneficiary need not live the life of the oil wildcatter or bear his risks to obtain the benefits of percentage depletion.

When it comes to capital gains what "equities" are to be applied? Is it fair that earned income pay a heavier tax?

A son who spends $1,000 on his destitue father does not get the same tax benefit as he who pays a like sum to his alma mater. Louis Eisenstein pursues example after example of so-called inequities in tax laws in his book The Ideologies of Taxation (1961). For example, the profits on the sale of unbred pigs are taxable as ordinary income, while the profits on the sale of pigs once bred

are taxable as capital gains. *Id.*, 174. The same is true of turkeys but not of chickens, even though "a bred chicken and a bred turkey are similarly situated. Each has feathers and two legs." *Ibid.*

Treasury recently noted numerous basic inequities resulting in preferred tax treatment for some people's dollars. Tax Reform Studies and Proposals, U. S. Treasury Dept., Joint Publication House Committee on Ways and Means and Senate Committee on Finance, 91st Cong., 1st Sess., Pt. I, pp. 13–14.

Apart from certain aspects of percentage depletion were the reduced taxation on long-term capital gains and the exclusion of interest on state and local government bonds. The examples are legion. The Tax Reform study gives an unusual example:

> "An individual had a total income of $1,284,718 of which $1,210,426 was in capital gains, the remaining $72,929 from wages, dividends, and interest. He excluded one-half of his capital gains, which he is allowed to do under present law, thereby reducing his present law (adjusted gross) income to $679,405 after allowing for the $100 dividend exclusion). From this income he subtracted all his personal deductions, which amounted to $676,419 and which included $587,693 for interest on funds borrowed presumably for the purpose of purchasing the securities on which the capital gains were earned. As a result, after allowing $1,200 of personal exemptions his taxable income was reduced to $1,786 and he paid a tax of $274. His overall tax rate, therefore, was about two-hundredths of one percent." *Id.*, p. 15.

This was made possible by using a taxpayer's deductions only against that part of his income which is subject to the tax, ignoring the excluded part.

Tax laws are indeed arbitrary; the lines they draw are the products of pressures inside the Congress with compromises carrying the day.

The Court of Appeals held that the "item" here in question was properly included in "gross income" prior to 1958 and was an allowable "deduction" in 1958 because the taxpayer did not have "an unrestricted right" to a "portion of such item," and that the amount of such deduction exceeds $3,000—all as provided in § 1341.[1] *Skelly Oil Co.* v. *United States*, 392 F. 2d 128, 131.

There is no irregularity on the face of the return. There is no conflict with any decision of any other Court of Appeals. We are asked, however, to put a gloss on the statute that Treasury desires. I would adhere to the construction given to the Court of Appeals leaving to Congress the correction of any inequities in the tax scheme.

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[1] Section 1340 reads as follows:

(a) General rule—If—

"(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item:

"(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

"(3 the amount of such deduction exceeds $3,000,

"then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

"(4) the tax for the taxable year computed with such deduction; or

"(5) an amount equal to—

"(A) the tax for the taxable year computed without such deduction, minus

"(B) the decrease in tax . . . for the prior taxable year . . . which would result solely from the exclusion of such item . . . from gross income for such prior taxable year . . . ."

The Congress many years ago created the Joint Committee on Internal Revenue Taxation, which is a standing committee. 26 U. S. C. §§ 8001–8005, 8021–8023. One of its statutory mandates is "To investigate the operation and effects of the Federal system of internal revenue taxes." *Id.*, § 8022.

In that connection a recent report states:

> ". . . the Joint Committee staff has in recent years been used as a committee liaison with the Treasury Department in working on tax proposals for the committee. The staff aids the two tax committees in explaining provisions, in writing committee reports, and in aiding in the drafting of bills."

The Joint Committee makes regular reports to Congress for revision of the tax laws. Inequities that arise as a result of interpretations that are given existing laws either at the administrative or judicial level can be quickly corrected by this agency of oversight.[2]

Treasury unhappily has developed the habit of jockeying in the courts, testing one theory against another. In California, it may take one position and in Massachusetts the opposite position, the issue in each being the same. The hope is that conflicts over litigious and important issues will develop and the case brought here.[3]

If we were trained in the art and science of taxation, we might serve a useful function. But taxation is a

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[2] Perhaps the most egregious error that we made in my time (one for which I take partial blame), was *Helvering* v. *Hallock*, 309 U. S. 106, an opinion for the Court, written by Mr. Justice Frankfurter that overruled *Helvering* v. *St. Louis Trust Co.*, 296 U. S. 39, and *Becker* v. *St. Louis Trust Co.*, 296 U. S. 48. This is one classic example of the type of problem which should be left to the Joint Committee.

[3] For a classical example see Paul, Studies in Federal Taxation (3d series 1940), pp. 449–450.

specialty in which we have only sporadic and no continuous experience. It has been said that one of our decisions is like a "lightning bolt" that "illuminates only a very small portion of the landscape," leaving a darkness that later decisions do not remove. Paul, Studies in Federal Taxation, pp. 249–250 (3d ed. 1940). Our contributions, if such they can be called, are dubious indeed, for the Joint Committee can and does rewrite the Code frequently.

It is therefore the rare tax case[4] we should consider, except the even rarer constitutional case. The present case has no constitutional overtones; the taxpayer followed the words of the tax law literally, using no new or strained construction of words to find a tax advantage; there is no conflict between this case and any other decision. The Solicitor General only claims that the result reached by the Court of Appeals does not fit the neat logic which he finds in a group of related tax cases.

An account of the cost, confusion, and inequity in tax administration that ensues while everyone waits for a conflict among the Circuits (which takes at least 10 years) is related in Griswold, The Need for a Court of Tax Appeals, 57 Harv. L. Rev. 1153 (1944). The role we presently play was stated as follows:

> "Our present system of tax adjudication inevitably leaves nearly every question uncertain during the entire period while it must be dealt with, usually in thousands of instances, by the administrative officers. And yet that is just the period when there should be an authoritative rule if the system is to

[4] The validity of Regulations and the effect of re-enactment of a statutory provision on them present distinct questions. *Helvering* v. *Wilshire Oil Co.*, 308 U. S. 90; *Commissioner* v. *South Texas Co.*, 333 U. S. 496; *Commissioner* v. *Stidger*, 386 U. S. 387.

> work smoothly, effectively, speedily, fairly, and without discrimination. Under our present system delay and discrimination are typical and inevitable." *Id.*, p. 1161.

In absence of an unmistakably clear conflict among the Circuits, I would abide by the opinions of the Courts of Appeals in tax cases and leave to the Joint Committee whether the gloss which Treasury now tries to put on the statue is or is not desirable.

SUPREME COURT OF THE UNITED STATES

No. 280.—October Term, 1968.

United States, Petitioner, v. Skelly Oil Company. | On Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit.

[April 21, 1969.]

Mr. Justice Stewart, with whom Mr. Justice Douglas and Mr. Justice Harlan join, dissenting.

The Court today denies the respondent a tax benefit fairly provided by the Code for no other discernible reasons than that, under the statute as written, "the taxpayer always wins and the Government always loses," [1] and that "the approach here adopted will affect only a few cases." *Ante*, at 8. But we are not free, even in a few cases, to abandon settled principles of annual accounting and statutory construction merely to avoid what the Court thinks Congress might consider an "inequitable result." [2]

> "[T]he rule that general equitable considerations do not control the measure of deductions or tax benefits cuts both ways. It is as applicable to the

[1] Section 1341, of course, is designed precisely to create a situation where "the taxpayer always wins and the Government always loses." Strict adherence to annual accounting and the claim of right doctrine before 1954 sometimes benefited the taxpayer, sometimes the Government. Section 1341 retains those principles where they benefit the taxpayer but allows recomputation of the taxes of a prior year if that method would result in a greater tax saving.

[2] Judicial assumptions that Congress did not intend liberal benefits for taxpayers are particularly suspect in the area of percentage depletion, perhaps the most generous business deduction in the Code. And Congress had the recipients of percentage depletion specifically in mind when it drafted § 1341. The House bill excluded

> Government as to the taxpayer. Congress may be strict or lavish in its allowance of deductions or tax benefits. The formula it writes may be arbitrary and harsh in its applications. But where the benefit claimed by the taxpayer is fairly within the statutory language and the construction sought is in harmony with the statute as an organic whole, the benefits will not be withheld from the taxpayer though they represent an unexpected windfall." *Lewyt Corp.* v. *Commissioner*, 349 U. S. 237, 240.

From any natural reading of § 1341, it is apparent that Congress believed the "deduction" in § 1341 (a)(2) would be in the amount of the "item" described in § 1341 (a)(1). If that understanding is not manifest from the face of the statute and the legislative history,[3] it is the unavoidable inference from a study of the pre-1954 law which

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from the coverage of § 1341 all refunds relating to inventory sales. The Senate Committee promptly removed refunds by regulated utilities from this exclusion with the following remarks:

"Your committee's bill provides that the exclusion of refunds pertaining to inventory sales will not exclude from the benefits of this section refunds made by a regulated public utility where the refunds are required to be made by the regulatory body, such as the Federal Power Commission. It is made clear, for example, that refunds of charges for the sale of natural gas under rates approved temporarily would be eligible for the benefits of this section." S. Rep. No. 1622, 83d Cong., 2d Sess., 118 (1954).

[3] The House and Senate Reports give no indication that Congress thought the deduction would be other than the amount of the item included in gross income for the prior year. They refer to the amount of the deduction and of the item interchangeably.

"If the taxpayer included an item in gross income in one taxable year, and in a subsequent taxable year he becomes entitled to a deduction because the item or a portion thereof is no longer subject to his unrestricted use, and the amount of the deduction is in excess of $3000, the tax for the subsequent year is reduced by either the tax attributable to the deduction or the decrease in the tax for the prior year attributable to the removal of the item, whichever is

the Court concedes § 1341 (a)(4) was intended to codify. In every case in this area previously decided by the Court the amount deductible in the year of repayment was considered to be exactly the same as the amount of the previously included item. In two of the cases most sharply in congressional focus in 1954, the Government had conceded without hesitation that the taxpayers were "entitled to a deduction for a loss in the year of repayment of the amount earlier included in income." *Healy* v. *Commissioner*, 346 U. S. 278, 284. See also *United States* v. *Lewis*, 340 U. S. 590, 591. That has been the express position of the Treasury since at least 1936,[4] and the Court today has not cited a single instance of deviation from that understanding.

The Court says that § 1341 is not alone controlling and that "it is necessary to refer to other portions of the Code to discover how much of a deduction is allow-

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greater. Under the rule of the *Lewis* case (340 U. S. 590 (1951)), the taxpayer is entitled to a deduction only in the year of repayment.

"In the case of a cash-basis taxpayer, in order to be entitled to a deduction in the later year, the amount must be repaid. However, in the case of an accrual-basis taxpayer, if the item was accrued but never received, the section applies when the deduction accrues in the later year although there is, of course, no amount to be repaid." S. Rep. No. 1662, *supra*, n. 2, at 451.

See also H. R. Rep. No. 1337, 83d Cong., 2d Sess., A294 (1954).

[4] See G. C. M. 16730, XV–1 Cum. Bull. 179, 181 (1936):

"In the instant case the taxpayer received the income under a claim of right and without restriction as to its disposition. On authority of the cases cited herein, this office is of the opinion that the profits in question should not be eliminated from the taxpayer's gross income for the years 1928 and 1929 [the years of inclusion], *but that the taxpayer is entitled to a deduction, for the year in which paid, of the amount of the profits paid* . . ." (Emphasis supplied.)

See also 2 Mertens, Law of Federal Income Taxation § 12.106a, at 431 (Zimet & Stanley rev. ed. 1967).

able." *Ante*, at 5. I agree that § 1341 must be considered in the context of the Internal Revenue Code as an "organic whole." But no other provisions of the Code in any manner bolster the Court's argument. The Court assumes, quite correctly, that either § 162 or § 165 does permit a deduction for the refund. But it does not, and cannot, suggest that either of those sections—or any other statutory provision—limits the amount of the deduction for the undeniable loss of profits in the full amount of the repayment. Instead the Court assumes a broad equitable authority to weed out tax benefits which it calls "double deductions"—a characterization wholly inapposite to the facts of this case.

In prior decisions disallowing what truly were "double deductions," the Court has relied on evident statutory indications, not just its own view of the equities, that Congress intended to preclude the second deduction. In those cases the taxpayers sought to benefit twice from the same statutory deduction.[5] In this case, by con-

[5] *Ilfeld Co.* v. *Hernandez*, 292 U. S. 62, and *United States* v. *Ludey*, 274 U. S. 295, both involved situations in which the taxpayer tried to take the same deduction twice. In *Ilfeld* the taxpayer had taken deductions, through consolidated returns, for the annual losses of its subsidiaries; when the subsidiaries' assets were sold and the companies dissolved, the parent taxpayer sought to take deductions for losses of its investment in the subsidiaries. As the Court held, "the allowance claimed would permit [the parent] twice to use the subsidiaries' losses for the reduction of its taxable income," a double deduction that "nothing in the Act purports to authorize . . . ." 292 U. S., at 68. In *Ludey* the taxpayer had taken deductions for depletion of his mining properties; but when the properties were sold in the taxable year in question, the taxpayer did not, in computing the gain from the sale, adjust the basis of the property to reflect the depletion deductions. The Court held that depletion allowances, like those for depreciation, are granted in recognition of the fact that the asset is disappearing year by year. When it is disposed of, therefore, "the thing then sold is not the whole thing originally acquired. The amount of the depreciation

trast, the respondent has taken two different deductions accorded by Congress for distinct purposes. In the years 1952 through 1957 it deducted the proper amounts for depletion—a deduction which is allowed by Congress "on the theory that the extraction of minerals gradually exhausts the capital investment in the mineral deposit," and which is "designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted, the owner's capital is unimpaired." *Commissioner* v. *Southwest Exploration Co.*, 350 U. S. 308, 312. The respondent's 1958 deduction was granted by Congress for the entirely different reason that the refund of previously reported income constituted a loss, or business expense. In purpose and effect the deductions are wholly unrelated, and each is sustainable on its own merits. Certainly it cannot be said either that the respondent did not in fact exhaust the capital assets for which the deductions were allowed in 1952 through 1957 or that it did not suffer a business loss by the 1958 repayment.

The sole nexus between these distinct transactions on which the Court constructs its "double deduction" theory is that the depletion deductions were computed as a percentage of gross income from the property. But this fact cannot distinguish percentage depletion from any other deduction. If the respondent had elected to take cost depletion in 1952 through 1957, for example, there would also have been a portion of the gross income in those years—perhaps less that 27½%, perhaps more—which was not included in taxable income. Whether a deduction is computed as a fixed percentage of income or in some other manner, it always reduces by some per-

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must be deducted from the original cost of the whole in order to determine the cost of that disposed of in the final sale of properties. Any other construction would permit a double deduction for the loss of the same capital assets." 274 U. S., at 301.

centage the income which is ultimately taxed. There are other deductions, of course, whose amount is a function of a certain percentage of the taxpayer's income. With respect to the individual taxpayer, the standard 10% deduction, § 141, and those for charitable contributions, § 170, and medical expenses, § 213, are doubtless the most frequent. Under the Court's ruling today, any taxpayer who repays money included in gross income in a prior year in which he also took one of the above mentioned deductions will have to reduce his refund deduction by that portion of the previous year's deduction attributable to the included income. Surely this result contravenes the purpose of the annual accounting concept to prevent recomputations of the prior year's tax.

The Court says today that there can be no deduction "for refunding money that was not taxed when received." *Ante*, at 7. This means nothing less than that, whenever a taxpayer seeks to deduct a refund of money received as income under a claim of right in a prior year, the deduction must be reduced by the percentage of gross income in that prior year which, for whatever reason, was not also taxable income. Otherwise there will be precisely the same kind of so-called "double deduction" as the Court finds in this case.

It is clear that the Court has wrought a major transformation of the deduction which has heretofore been allowed and which Congress recognized in § 1341 (a)(4). That deduction is permitted because, in the words of § 1341, the item "was included in *gross* income for a prior taxable year" (emphasis added), not because it was included in *taxable* income. It is no answer to say that the "annual accounting concept does not require us to close our eyes to what happened in prior years." *Ante*, at 6. Of course we must look to the prior years to ascertain the amounts included in gross income and

the nature of that income as it bears on the provision under which it is deductible in the year of repayment. *Arrowsmith* v. *Commissioner*, 344 U. S. 6.[6] But the very purpose of the annual accounting concept is to preclude adjustments in the amount of the deduction to reflect the tax consequences of the item's inclusion in the prior year.

> "Congress has enacted an annual accounting system under which income is counted up at the end of each year. It would be disruptive of an orderly collection of the revenue to rule that the accounting must be done over again to reflect events occurring after the year for which the accounting is made, and would violate the spirit of the annual accounting system. This basic principle cannot be changed simply because it is of advantage to a taxpayer or to the Government in a particular case that a different rule be followed." *Healy* v. *Commissioner*, 345 U. S. 278, 284–285.

One of the major factors, in addition to changes in tax rates and brackets, that determine who will benefit from adherence to the annual accounting principles embodied in § 1341 (a)(4) is the extent to which the taxpayer had deductions in the prior or subsequent taxable years to offset gross income. And it is no less inconsistent with annual accounting principles to pare down the allowable loss deduction in the year of repayment

[6] As the Court recognizes, *ante*, at 7, n. 4, the Court in *Arrowsmith* did not hold that the amount of the deduction in the year of repayment would be reduced because in the year of inclusion the money had been taxed at a lower rate or had been offset by deductions. It held merely that the losses fell within the definition of "capital losses" contained in the sections authorizing deductions for the repayment. The Court does not in this case point to any comparable statutory provision affecting the nature or amount of the deduction for the refund.

because of other deductions in the year of inclusion than because of a lower tax rate or bracket in that year.

Because I cannot agree that the Court's equitable sensibilities empower it to depart from the sound principles of tax accounting specifically endorsed by Congress in § 1341, I respectfully dissent.